

Articles

EXAMINING THE PIPELINE: A CONTEMPORARY ASSESSMENT OF PRIVATE INVESTMENTS IN PUBLIC EQUITY (“PIPES”)

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I. INTRODUCTION

An explosion of capitalistic innovation has profoundly impacted the modern investment landscape.¹ This increase in entrepreneurial activity has precipitated a corresponding increase in the demand for capital both for starting new business ventures and for managing a pre-existing company’s operational needs for capital.² As a result, capital formation, as defined as a company’s ability to effectively and efficiently raise capital for various needs at different junctures in its life, will undoubtedly remain an integral economic process. Fortuitously, this increased demand for capital has been matched by an increase in modernized capital-financing alternatives. For example, companies may be able to access the trillion dollar equity or debt markets, such as the Rule 144A markets.³ Similarly, these companies may

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1. See Steven Dresner, *Introduction to PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY* 4 (Steven Dresner & E. Kurt Kim eds., rev. & updated ed. 2006) (“Changing market dynamics will forever impact the capital requirements of issuers and the risk/return tolerances of investors. The need to bridge the two promotes continuous innovation in the design of deals.”).

2. *Id.*; MARC I. STEINBERG, *UNDERSTANDING SECURITIES LAW* § 3.01 (4th ed. 2007).

3. See Scott J. Gelbard, *Institutional Private Placements and Other Financing Alternatives*, in *PRACTISING LAW INSTITUTE CORPORATE LAW & PRACTICE COURSE HANDBOOK COURSE HANDBOOK SERIES* 532 (1997) (“Rule 144A provides a safe harbor exemption from the registration requirements of the Securities Act of 1933, as amended, for

seek to tap into alternative pools of capital by conducting registered public offerings or by employing various other mechanisms that, if effectively utilized, provide them with financing for their various needs.⁴

While the recent increase in the array of financing options available for enterprises paints an optimistic picture for a company seeking capital, several realities diminish a wholesale acceptance of this proposition. First, market dynamics can often adversely impact a company's ability to raise capital.⁵ To illustrate, a recent comprehensive assessment of U.S. markets indicates that these markets are experiencing a significant decline in competitiveness.⁶ This deterioration may effectively depress economic activity, reducing the willingness of financial institutions to undertake the requisite funding and otherwise severely impeding capital formation optimization.⁷ As a consequence of these recent market developments, companies are increasingly in search of innovative solutions to their

resale of unregistered securities to Qualified Institutional Buyers ('QIBS')."); Stephen M. Graham, *Financing Alternatives for Public Companies*, in PRACTISING LAW INSTITUTE CORPORATE LAW & PRACTICE COURSE HANDBOOK SERIES 111-116 (2006) (describing the general structure of Rule 144A debt offerings); *see also* Sagient Research, <http://www.sagientresearch.com/pt/Gstats.cfm?Type=2> (last visited Oct. 21, 2008) (recognizing 117 deals transacted under Rule 144A exemptions totaling \$52,321,981,500, in 2007).

4. *See* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, GOING PUBLIC HANDBOOK § 2:78 (2007) (stating that private placement and offshore offerings are common alternatives to financing in the securities market); Gabriel Nahoum, Note, *Small Cap Companies and the Diamond In the Rough Theory: Dispelling the IPO Myth and Following the Regulation A and Reverse Merger Examples*, 35 HOFSTRA L. REV. 1865, 1898-1908 (2007) (discussing the pros and cons of regulation A exemptions and reverse mergers as alternatives to registered public offerings). *See generally* RICHARD A. BOOTH, FINANCING THE CORPORATION § 1:8 (2008) (discussing sources of capital for established businesses).

5. COMMITTEE ON CAPITAL MARKETS REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET 32 (2007), available at http://www.capmktreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf ("By almost any meaningful measure, the competitive ness of the U.S. public equity market has significantly deteriorated in recent years. From 2006 to 2007, most measures [assessing the U.S. markets] either continued to decline or failed to substantially improve."); *see also id.* (noting that continuation of this trend will likely have a significant negative impact on the activity of U.S. capital markets, including the formation and efficient allocation of capital).

6. *Id.* (noting that the decline in the competitiveness of the U.S. private equity markets has a negative impact on the U.S. economy in aggregate and is "continuing amid challenging market conditions worldwide and growing concern about U.S. economic fundamentals").

7. *Id.* This deterioration is compounded by other regulatory developments that also have arguably impeded effective capital formation. *See also* Task Force on Hedge Funds, *Report on Section 3(C)(1) of the Investment Company Act of 1940 and Proposals to Create an Exception for Qualified Purchasers*, 51 BUS. LAW. 773, 791 (1996) (calling for a reexamination of the rationale of Section 3(c)(1) due to its impediment on investment vehicles, and thus, on capital formation).

financing needs.⁸ More than ever, affected companies aggressively seek financing options that offer the dual objectives of versatility and efficiency.

One recent financing alternative that is steadily gaining recognition as a viable capital formation mechanism is a “private investment” in public equity, or PIPE.⁹ To a large degree, PIPEs are increasingly viewed as an economical and efficient means for a publicly-traded company to procure capital funding. This level of approbation in the United States is due in part to the legal and regulatory U.S. framework that enables these transactions to be consummated with relative ease.¹⁰ PIPEs are particularly important in the contemporary financing environment as current market conditions preclude many companies from accessing traditional public and private sources of financing.¹¹

From a transactional perspective, PIPEs are privately issued equity or equity-linked securities that are normally sold to “accredited investors”¹²

8. See Mihkel E. Voore & Leela Hemmings, *Evolution of the Unallocated Shelf Prospectus*, CORP. FIN. 2 (2003), available at <http://www.stikeman.com/newslett/CorpFinancing04.pdf> (“Securities regulators in the United States and Canada have been called upon increasingly in recent years to demonstrate flexibility in the face of market realities and competitive challenges and to be sensitive to the proposition that the speed and efficiency with which issuers can gain access to capital markets directly affects their success.”); see also Laura Mueller, *The Big Squeeze*, AIRLINE BUS., Feb. 2008, at 48 (“[U]ncertain market conditions could result in fewer capital market financings, as the costs of these deals have risen relative to the economic benefits realized by their issuers.”).

9. See Dresner, *supra* note 1, at 1 (“The use of PIPEs as a means to raise capital continues to grow as those in the financial markets and managers of public companies gain increasing access to information on the topic of private investments in public equity.”).

10. See Barbara A. Jones et al., *Structuring PIPE Transactions in Key European Jurisdictions*, 37 INT’L L. 23, 23 (2003) (“PIPE transactions have not enjoyed the same level of popularity in Europe as in the United States, in large part because the legal and regulatory framework in many European jurisdictions hinder the ease with which such transactions can be completed”).

11. See *supra* notes 7-8 and accompanying text; see also Richard E. Gormley, *Overview: An Emerging Market, in PIPEs: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY*, *supra* note 1, at 10 (“PIPEs . . . provide an alternative financing vehicle for public companies in circumstances in which a public follow-on equity or equity-linked offering is not desirable, advisable, or possible.”). See generally Graham, *supra* note 3, at 79 (discussing how it is increasingly more common for public companies in need of capital to choose alternative sources of funding other than traditional public offerings).

12. 17 C.F.R. § 230.501(a) (2008) (defining an “accredited investor [as] any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories . . . at the time of the sale of the securities to that person”:

- 1) Any bank as defined in Section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in Section 3(a)(5)(A) of the Act, whether such bank, savings and loan association, or other institution is acting in its individual or fiduciary capacity;
- 2) Any broker or dealer registered under the Exchange Act and purchasing for

by public companies in a hybrid transaction typically involving a Regulation D private placement¹³ followed by a registered public

its own account;

3) Any insurance company as defined in Section 2(a)(13) of the Securities Act;

4) Any registered investment company or business development company;

5) Any licensed small business investment company;

6) Any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5 million;

7) Any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA) if (i) the investment decision is made by a plan fiduciary, which is either a bank, savings and loan association, insurance company, or registered investment adviser; or (ii) the employee benefit plan has total assets in excess of \$5 million; or (iii) the plan is a self-directed plan, with investment decisions made solely by persons who are accredited investors;

8) Any private business development company as defined in Section 202(a)(22) of the Advisers Act;

9) Any Internal Revenue Code Section 501(c)(3) exempt organization, corporation, limited liability company, Massachusetts or similar business trust, or partnership—with total assets in excess of \$5 million not formed for the specific purpose of acquiring the securities offered;

10) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

11) Any natural person whose (i) individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds \$1 million, or (ii) income or joint income with that person's spouse exceeds \$200,000 or \$300,000, respectively, in each of the two most recent years, and who has a reasonable expectation of reaching that same income level in the current year;

12) Any trust with total assets exceeding \$5 million not formed for the specific purpose of acquiring the securities offered, and whose purchases are directed by a sophisticated person; and

13) Any entity in which all equity owners are accredited investors.)

See also 15 U.S.C. § 80a-2(51)(a) (defining “qualified purchaser” as stated in the 1940 Investment Company Act); Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116 (Aug. 10, 2007) (explaining the SEC’s proposal to add a new class of individual accredited investors—namely those individuals who have at least \$750,000 in investments).

13. 17 C.F.R. § 230.506. Rule 506 of Regulation D is the provision normally invoked in this context. *See* 15 U.S.C. § 77r(a)(1933) (stating that offerings conducted pursuant to Rule 506 are state-preempted with respect to the exemption and registration mandates). *See generally* Harold S. Bloomenthal & Samuel Wolff, *Under State Blue Sky Laws—Federal Preemption—Rule 506 Offerings*, 10 INT’L CAP. MARKETS & SEC. REG. § 10:37 (2003) (discussing preemption provisions added by The National Securities Markets Improvement Act of 1996 (NSMIA), the most significant of which includes a rule adopted under Section

offering.¹⁴ PIPE issuers range in size from small, over-the-counter (“OTC”) bulletin board companies to large-cap, NYSE-traded companies.¹⁵ In terms of transaction frequency, PIPEs have dramatically increased from the 306 transactions recorded in 1996 to the 1,454 deals that were closed in 2007.¹⁶ The aggregate PIPE deal value during this same period also has grown from just over \$4 billion dollars to a whopping \$83 billion dollars—a staggering increase.¹⁷

Although once considered a financing alternative of last resort used mainly by cash-strapped companies or issuers otherwise unable to secure traditional sources of capital,¹⁸ the PIPE market now attracts sophisticated market players.¹⁹ Several factors are responsible for PIPE’s emergence as a viable capital-raising alternative. Regulatory changes, the increasing difficulty of accessing so-called traditional capital sources previously alluded to, and entrepreneurial ingenuity have all contributed to PIPE’s

4(2) of the Securities Act, which includes Rule 506, but not Rule 505 and 504 offerings).

14. See Dresner, *supra* note 1, at 1.

15. See Gornley, *supra* note 11, at 19 (“The PIPE/RD issuer universe is populated by small-cap and mid-cap growth companies, although an increasing number of companies with larger market capitalizations and/or in traditional industries have begun to utilize these financing formats”); see also Steve Winters, MANAGING RISK: SECURITIES STRUCTURES, TRADING AND DEAL DOCUMENTATION, IN PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY, 205 (rev. and updated ed. 2006) (“PIPEs have continued to attract an extremely diverse group of professional investors, ranging from Warren Buffett’s Berkshire Hathaway to traditional mutual fund investors and numerous hedge funds pursuing an arbitrage or deep value investment platform”).

16. Sagient Research, <http://www.sagientresearch.com/pt/GStats.cfm?Type=6> (last visited Oct. 21, 2008); see also William K. Sjostrom, Jr., *PIPEs*, 2 ENTREPRENEURIAL BUS. L.J. 381, 382 (2007) (noting that PIPEs have become an important source of financing for many small public companies).

17. Sagient Research, *supra* note 16 (indicating an \$83 billion aggregate PIPE deal value in 2007—a \$55 billion jump from the \$29 billion aggregate in 2006); see also Sjostrom, *supra* note 16, at 382 (noting that the success enjoyed by hedge funds in investing in PIPEs has been so great that in the last two years, the SEC has brought a number of enforcement actions against the hedge funds accusing them of insider trading and violations of the registration requirements of the Securities Act in connection with PIPE investments).

18. See Sjostrom, *supra* note 16, at 381-82 (finding that “[w]hile companies of all sizes have used PIPEs to raise money, PIPE deals have emerged as a vital financing source for small public companies.”); see *id.* at 382 (observing that the PIPE deals completed in 2006 were generally executed by companies with market capitalizations of \$250 million or less and that these statistics are often attributable to the “reality that PIPEs represent the only available financing option for many small public companies”); Susan Chaplinsky & David Haushalter, Financing Under Extreme Uncertainty: Contract Terms and Returns to Private Investments in Public Equity 2 (May 2006) (unpublished article), available at <http://ssrn.com/abstract=907676> (stating that firms that face difficulty raising capital through traditional financing instruments often use PIPEs).

19. See Dresner, *supra* note 1, at 27 (“The PIPE marketplace has been utterly transformed during the past decade from a fledgling cottage industry into a dynamic and robust sector of the corporate finance landscape.”); see also WINTERS, *supra* note 15, at 205-206 (commenting on the diverse group of professional investors that PIPEs attract).

rising popularity.²⁰

Despite this rising popularity, scant comprehensive coverage has been given to PIPEs and their role in the overall capital formation landscape, particularly in light of recent significant regulatory developments. The purpose of this article is to highlight PIPEs as an alternative financing technique, in light of recent changes in the regulatory framework within which PIPEs and similar financing transactions are executed. To this end, Part II sets the stage for a comprehensive discussion of PIPEs by providing an overview of the traditional financing sources typically available to companies. Part III then provides a substantive evaluation of PIPEs and covers topics including the definition of a PIPE, the PIPE market, and the investment benefits generally attributed to PIPEs. Part IV continues the discussion of PIPEs and focuses primarily on the recent regulatory developments that have positioned PIPEs ideally in the capital formation arena. Part V asserts that, on balance, PIPEs deservedly have emerged as a viable capital formation alternative, concluding that, given the uncertainty engendered by recent regulatory developments, both issuers and investors must proceed with PIPE transactions in a strategic manner.

II. OVERVIEW OF TRADITIONAL CAPITAL FORMATION OPTIONS

This section provides an overview of the traditional capital financing alternatives and focuses primarily on registered public offerings and private placements. While there are a plethora of ways to finance transactional structures, both conventional and exotic, these options generally involve either a public offering, a private placement or a combination thereof. As such, this section's analysis focuses on the public offering and private transactional exemptions.²¹

A. *Registered Public Offerings*

Section 5 of the Securities Act of 1933 (the "1933 Act") is the foundation of the federal securities law regulatory framework as it pertains

20. See, e.g., Marine Cole, *Debt Strain Unclogs PIPEs: Bank of America's \$2 billion investment in Countrywide marks the return of private investments in public equity*, FIN. WEEK, Sep. 10, 2007, <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070910/REG/70907014/1005/TOC> (noting that some companies, especially mortgage-related and small-cap companies, have turned to PIPEs because access to bank loans has become difficult in the wake of the subprime mortgage crisis).

21. For a comprehensive discussion of the various financing alternatives available, see Abigail Arms, *The Private Placement Alternative to a Public Offering*, in PRACTISING LAW INSTITUTE CORPORATE LAW & PRACTICE COURSE HANDBOOK SERIES 135 (2004) (providing an overview of the private offering and resale exemptions available to issuers and investors under the Securities Act of 1933).

to registered public offerings. Pursuant to section 5, it is unlawful for any person to sell securities unless a registration statement, filed with the Securities and Exchange Commission (the "SEC"), is effective.²² In addition to setting forth the basic registration requirement, section 5 also articulates the prospectus delivery rules which state that a final statutory prospectus compliant with Section 10(a) of the 1933 Act must be accessible or delivered to the investor at or prior to the sale of a registered security.²³ While the registration requirement creates a formidable regulatory paradigm in the context of public offerings, there are several exemptions to this requirement that, if effectively perfected, allow an issuer to sell securities absent the filing of a registration statement.²⁴ These exemptions are discussed more fully later in this section of the article. Note, moreover, that irrespective of the Securities Act registration regimen, market conditions, costs of undertaking a public offering, and competitive challenges to induce reputable investment banks to underwrite a public offering pose significant hurdles for an unseasoned or financially troubled issuer to successfully effectuate a public offering.²⁵

Under the 1933 Act and the rules and regulations promulgated thereunder, a subject issuer has certain options, depending on its unique circumstances and overall profile, to undertake a registered public offering. These options may be principally distinguished by the disclosure requirements that are applicable to each of them and the manner in which those disclosure requirements can be satisfied.²⁶ The predominant

22. 15 U.S.C. § 77e(a) (2006). This discussion simplifies the cumbersome registration requirements. The SEC significantly revised and deregulated these mandates in 2005. See Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722 (Aug. 3, 2005) (adopting new rules to "eliminate unnecessary and outmoded restrictions on offerings"); MARC. I. STEINBERG, *SECURITIES REGULATION* §§ 4.01-4.02 (5th ed. 2008) (providing discussion and materials on the registration process); Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U. L. REV. 561, 563-65 (2007) (providing an analysis of the 2005 revisions).

23. 15 U.S.C. § 77e(b), (c) (2006); Securities Act Release No. 8591, 70 Fed. Reg. at 44,722. As part of the 2005 offering reform, the SEC eliminated prior Rule 434 and adopted a more flexible access-as-delivery approach in Rule 172. See Securities Act, 17 C.F.R. § 230.172 (2005) (creating exemptions to prospectus requirement).

24. See, e.g., 17 C.F.R. § 230.506(a) (2006) (providing an exemption for private offerings irrespective of the monetary amount raised); see also STEINBERG, *supra* note 2, at 101 ("To protect investors and the integrity of the securities markets, the Securities Act of 1933 (Securities Act or 1933 Act) has two basic objectives: (1) to provide investors with adequate and accurate material information concerning securities offered for sale and (2) to prohibit fraudulent practices in the offer or sale of securities").

25. See STEINBERG, *supra* note 2, at 39, 122-25.

26. DAVID A. CIFRINO & THOMAS P. CONAGHAN, *THE PUBLIC COMPANY PRIMER: A PRACTICAL GUIDE TO GOING PUBLIC, RAISING CAPITAL AND LIFE AS A PUBLIC COMPANY* 47-48 (2007), available at <http://financial.rrd.com/wwwFinancial/Downloads/PDF/RR%20Donnelley%20Public%20Company%20Primer.pdf> (generally describing the various registration options available to a company seeking to conduct a registered public offering).

registration forms available to issuers are Form S-1 and Form S-3.²⁷

1. Registration Forms

a. *Form S-1*

Form S-1 is the basic form available to an issuer who wishes to “go public”²⁸ (or is otherwise ineligible to use a more simplified form) to register any of its equity or debt securities to be sold in a public offering.²⁹ Form S-1 is considered a general purpose form used for the registration of securities under the 1933 Act and is typically available to all issuing companies that are not eligible or required to use a different form.³⁰ The informational requirements that must be narratively set forth in a Form S-1 are the most expansive of all the available registration forms.³¹ These heightened disclosure obligations are, in large part, attributable to the fact that Form S-1 is the registration form that new entrants into the registered offering arena are required to use.³² Until an issuer becomes eligible to use

27. See 17 C.F.R. § 239.13 (2007) (describing SEC Form S-3); Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Securities Act Release No. 33-8878, 72 Fed. Reg. 73,534 (Dec. 27, 2007) (describing revisions to Forms S-1 and S-3).

28. “Going public” is the process by which a privately-held issuer becomes publicly-held under the federal securities laws. Harold S. Bloomenthal & Samuel Wolff, 3A SECURITIES AND FEDERAL CORPORATE LAW § 8:1 (2d ed. 2007); STEINBERG, *supra* note 2, at §§ 3.01, 4.01; see also Carl W. Schneider et al., *Going Public*, in 2 VENTURE CAPITAL AND SMALL BUSINESS FINANCINGS §§ 12:1, 12:22 (Robert Haft ed., 2008) (discussing the attendant costs of going public); Johnathan A. Koff & Michael Lee, *The Initial Public Offering Process*, in PRACTISING LAW INSTITUTE CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 114-16 (1997) (discussing the disadvantages associated with “going public,” including the increased risk of liability for directors under federal securities law).

29. See 17 C.F.R. § 239.11 (2006) (creating Form S-1, to be used for “securities of all registrants for which no other form is authorized or prescribed”).

30. See Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Securities Act Release No. 33-8878, 72 Fed. Reg. at 73,539 (“[A]n issuer that is temporarily prevented from utilizing Form S-3 for shelf offerings to raise capital would not be foreclosed from registering a primary offering of securities on Form S-1 or in private placements.”).

31. The informational requirements of SEC Form S-1 are contained in items 3-17. 17 C.F.R. § 239.11. Note also that the informational disclosure requirements for both the prospectus and subsequent portions of the Form S-1 registration statement are articulated by reference to the comprehensive disclosure requirements set forth in Regulation S-K and Regulation S-X. See BLOOMENTHAL & WOLFF, *supra* note 28, at § 5:40 (describing the requirements for disclosure under Regulation S-K); see also 1B HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 1B GOING PUBLIC AND THE PUBLIC CORPORATION § 12:30 (2007) (discussing the contents of the prospectus, i.e., the basic information package as well as the extensive in-depth information required by Form S-1 as contrasted with Form S-3).

32. 17 C.F.R. § 239.11. Form S-1 is divided into two primary categories: (i) Part I, which articulates the information required to be disclosed in the prospectus and (ii) Part II,

a different form, such as Form S-3, it is restricted to the use of Form S-1 for all offerings, even those made subsequent to the initial public offering (“IPO”).³³ Not surprisingly, due to the detailed disclosure that must be set forth if a subject issuer may not incorporate by reference³⁴ and the fact that compliance with such disclosure mandates may impede a company’s ability to quickly access capital markets,³⁵ Form S-1 is disfavored, particularly in the shelf offering context.³⁶

which provides the information that must be included in the registration statement, but is not expressly required to be included in the prospectus. *Id.* Note, however, that Form S-1 does not actually enumerate the informational disclosures for both the prospectus and the rest of the registration statement. Rather, Form S-1 contains references to more particularized disclosure requirements articulated by Regulation S-K and Regulation S-X. *Id.* See generally 17 C.F.R. §§ 210, 229 (dealing with the application of Regulation S-K and S-X).

33. 17 C.F.R. § 239.11. Pursuant to the Form S-3 instructions in effect up until recently, a company that wished to use Form S-3 was required to have a class of securities registered under the Securities Exchange Act of 1934 and to have timely made all filings required under the Exchange Act for at least the twelve months preceding the filing of the registration statement. In addition, the company was required to satisfy one of the form’s transactional requirements, depending on the type of offering to be conducted. For example, in order to conduct a primary offering, a company was required to have a non-affiliate equity market capitalization, or “public float,” of at least \$75 million. While the recent amendments to Form S-3 left many of these requirements in place, new General Instruction I.B.6 to Form S-3 expands the universe of potentially eligible users by providing certain situations in which companies with a public float of less than \$75 million are allowed to register primary offerings on Form S-3 provided that certain requirements are satisfied. *Id.*; see also *infra* notes 163-199 and accompanying text (providing a more comprehensive discussion of the recent Form S-3 amendments).

34. While issuers have historically been prohibited from incorporating by reference when relying on Form S-1, pursuant to the 2005 Offering Rule Reform, this Form now permits certain issuers to incorporate by reference from Exchange Act periodic reports (such as Forms 8-K, 10-K, and 10-Q). See Sjöstrom, *supra* note 16, at 394 n.90 (stating that allowing certain issuers to incorporate by reference from Exchange Act periodic reports has not significantly impacted PIPE issuers relying on Form S-1 because many were a blank check company, a shell company or a registered penny stock offering—entity types that are restricted from relying on the limited incorporation by reference available with the Form S-1); see also 17 C.F.R. § 239.11, Form S-1, General Instruction VII.

35. See Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Securities Act Release No. 33-8878, 72 Fed. Reg. at 247 (stating that the use of Form S-3 “allow[s] companies to avoid additional delays and interruptions in the offering process and can reduce or even eliminate the costs associated with preparing and filing post-effective amendments to the registration statement”).

36. See generally 17 C.F.R. § 230.415 (2006). For example, the automatic update feature that is available in the context of Form S-3 is not available to users of Form S-1. Consequently, such issuers using Form S-1 must manually update the shelf registration by filing supplements and or amendments with the SEC to incorporate information contained in the subject issuer’s periodic 1934 Exchange Act (the “1934 Act”) filings. See also Sjöstrom, *supra* note 16, at 394 (noting that the use of Form S-1 is likely to result in higher transaction costs for issuers given that these forms require more comprehensive disclosures, involve a longer preparation period, and often result in investors demanding higher discounts for compensation due to the longer period of illiquidity that the foregoing factors

b. Form S-3

Due to the availability of incorporation by reference from Exchange Act periodic reports into the registration statement, Form S-3 is typically the favored registration form.³⁷ Thus, a significant advantage that Form S-3 provides is that it permits securities to be offered pursuant to a registration statement setting forth only a limited amount of information, such as a description of the plan of distribution and the securities being offered, while much of the information is incorporated by reference from the issuing company's periodic filings made pursuant to the Exchange Act reporting framework.³⁸ As a consequence, Form S-3 constitutes a more versatile option, especially with respect to an issuer's ability to take advantage of shelf registration.³⁹

create).

37. See Sjorstrom, *supra* note 16, at 393 (generally describing the benefits associated with Form S-3); *infra* notes 163-199 and accompanying text (discussing recent amendments to Form S-3 eligibility requirements).

38. 17 C.F.R. § 239.13 (2006), SEC Form S-3. Of course, material facts that occurred after the filing of the most recent Exchange Act report must be disclosed in Form S-3. See Robert J. Haft & Peter M. Fass, 4 TAX-ADVANTAGED SECURITIES § 6:134 (2008) (stating that disclosure must be made in "quarterly updates to the risk factors disclosure to reflect any material changes from risks previously disclosed in Exchange Act reports"); see also BLOOMENTHAL & WOLFF, 1B GOING PUBLIC AND THE PUBLIC CORPORATION, *supra* note 31, at § 12:19.

39. See generally 17 C.F.R. § 230.415 (describing the conditions under which an offering and sale of securities may be delayed or continued). In this context, "shelf registration" is a term used for Securities Act registration pursuant to SEC Rule 415 in which an issuer essentially places the offering on the shelf, enabling such issuer to access the securities markets quickly when conditions become favorable. In at-the-market primary offerings, shelf registration is available to issuers capable of using a Form S-3. Issuers generally prefer using a shelf registration because of the advantages it offers, including a 3-year expiration date, favorable renewal options, elimination of limits for at-the-market equity offerings, automatic shelf registrations for well known seasoned issuers (WKSIs) (immediate effectiveness of registration statements) and a "pay as you go" filing system. A disadvantage inherent in shelf offerings is that each new prospectus supplement filed extends the statute of limitations for possible Section 11 liability. In sum, shelf offerings provide a convenient and efficient way for an issuer to quickly register stock and sell the subject securities in the open market. See Securities Act Release No. 33-8878, *supra* note 30.

While the foregoing forms, particularly Form S-3, normally are the preferred and predominant registration forms, they are not the only registration options. In particular, both Form S-4 and Form S-8 are specialized registration forms used in specific transactional scenarios. For example, Form S-4 is the registration forms used when registering securities that will be exchanged in a context involving an acquisition or similar business combination (e.g., mergers, consolidations, and similar transactions). As such, issuances of stock to the target company's shareholders in such acquisitions are generally registered on Form S-4. Form S-4, like Form S-3, permits the issuer to incorporate information about itself by reference to its periodic Exchange Act filings, assuming the issuer is eligible under applicable Form S-3 requirements. Similarly, Form S-8 is a specialized registration form

B. Registration Exemptions

While the foregoing discussion focused on registered public offerings, there are several exemptions from Securities Act registration. Depending on the circumstances, invocation of a particular exemption may enable an issuer to raise the requisite capital while avoiding the costs generally attributable to public offerings.⁴⁰ Absent an exemption, all sales of securities must be registered pursuant to Section 5 of the Securities Act.⁴¹ Moreover, unless the applicable state regulatory system for the sale of securities is preempted by federal law (such as pursuant to the 1996 National Securities Market Improvement Act⁴²) or an applicable state law offering exemption is met, the subject security generally must be registered in each state in which the issuer offers to sell the security.⁴³ However,

that allows public companies that file regular reports under the 1934 Act to register securities that are issued pursuant to employment-related stock awards and option plans. Essentially, Form S-8 enables Exchange Act reporting companies to issue shares to employees and consultants without having to comply with the more cumbersome registration Form S-1 or otherwise to perfect an exemption from Securities Act registration. In addition, Form S-8 also enables non-affiliate employees who receive these shares to resell such shares without having to comply with applicable resale limitations. 17 C.F.R. § 239.16(b), SEC Form S-8 (2006). See ROBERT J. WILD, CORPORATE COMPLIANCE SERIES: DESIGNING AN EFFECTIVE SECURITIES COMPLIANCE PROGRAM § 1:14 (2007) (“Form S-4 [is] used for securities to be issued as a result of a business combination or in an exchange offer such as those involving debt securities issued in a Rule 144A offering”); see also HR Series Comp. and Benefits § 10:69 (2nd Ed. 2008) (stating that Form S-8 was designed specifically for use in connection with non-statutory stock option plans implemented by employers).

40. See STEINBERG, *supra* note 2, at 38-39 (stating with respect to the preparation of the public offering registration statement, “[t]he disclosures required are detailed and complex, the document’s length is massive, and the costs of preparing the registration statement, including accountant, attorney, investment banker and printer fees, easily can run into the tens if not hundreds of thousands of dollars.” In light of the foregoing factors, “the costs of having a “registered” offering under the Securities Act frequently will be substantial.”).

41. 15 U.S.C. § 77e(a) (2006). The issuer bears the burden of proving that an exemption applies. *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953). Certain securities, such as municipal bonds, are exempt from Securities Act registration. See David J. Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 VAND. L. REV. 1599, 1629 (1986) (explaining that the Securities Act establishes a number of exemptions from securities registrations including, “‘exempt securities,’ principally comprised of United States government securities and municipal bonds, [which] need not be registered”).

42. National Securities Markets Improvement Act (NSMIA) of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3443 (1996) (“The Commission, by rule, may exempt any sale of securities . . . from any fee imposed by this section, if the Commission finds that such exemption is consistent with the public interest, the equal regulation of markets and brokers and dealers, and the development of a national market system.”).

43. See STEINBERG, *supra* note 22, at 132 (“With certain exceptions and subject to the preemptive provisions of the National Securities Market Improvement Act of 1996, unless an exemption from state registration is perfected, any offer or sale within a particular state must be registered.”).

irrespective of the availability of an exemption from registration, the antifraud provisions of both federal and state securities laws apply.⁴⁴ The following discussion briefly highlights issuer exemptions to the Section 5 registration requirement that have particular relevance in the PIPE context.

1. Section 4(2) Exemption

The Section 4(2) exemption specifically provides that all "transactions by an issuer not involving a public offering," are not subject to the Section 5 registration requirement.⁴⁵ The congressional intent underlying the Section 4(2) exemption is to exempt sales where there is no realistic need for such application or where the overall benefits are too remote.⁴⁶ While the Section 4(2) exemption historically has been viewed as the key statutory private placement exemption available to issuers,⁴⁷ its practical functioning is at times thwarted because the statute does not provide sufficient guidance with respect to its application.⁴⁸ As a result, issuers may be placed in the precarious position of ascertaining compliance with Section 4(2)'s terms from judicial and administrative interpretations that, at times, are ambiguous, at best.

The most relied upon judicial interpretation of the Section 4(2) exemption is the United States Supreme Court's decision in *SEC v. Ralston Purina Co.*⁴⁹ In that case, the Supreme Court made clear that the critical inquiry, with respect to the applicability of the Section 4(2) exemption, is whether the offerees are able to fend for themselves so as to render the registration mandate unnecessary. Key determinants in this inquiry are the financial sophistication of each offeree and whether each offeree was provided with, or had access to, the kind of information that is contained in a registration statement.⁵⁰ *Ralston Purina* and subsequent lower court

44. See STEINBERG, *supra* note 2, at 95 (noting that regardless of whether a transactional exemption is properly perfected pursuant to the applicable rules and guidelines, an issuing company will nonetheless be required to comply with antifraud restrictions imposed by a myriad of securities laws, namely the 1934 Act). The Rule 506 exemption is not within state regulation due to NSMIA preemption. See § 18(b)(4) of the Securities Act, 15 U.S.C. § 77r(b)(4) (describing certain exempt offerings).

45. 15 U.S.C. § 77d(2) (2006).

46. See H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933) (providing Congressional analysis of the Securities Act at the time of passage); see also *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) (examining congressional intent underlying the § 4(2) exemption).

47. See Carl W. Schneider, *Section 4(1-1/2)—Private Resales of Restricted or Controlled Securities*, 49 OHIO ST. L.J. 501, 503 (1988) (stating that § 4(2) "is the general exemption for so-called 'private placements'").

48. See Federal Regulation of Securities Committee, *Section 4(2) and Statutory Law*, 31 BUS. LAW. 485, 485 (1975) (noting uncertainty in application of § 4(2)).

49. 346 U.S. 119 (1953).

50. *Id.* at 126-27; *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 900 (5th Cir. 1977).

decisions examine several factors in order to determine Section 4(2)'s applicability in purportedly private transactions:

- the number of offerees and their relationships to each other and to the issuer;
- the manner of the offering;
- the sophistication and expertise of the offerees;
- the nature and type of information provided to offerees either directly or indirectly (i.e., by giving access); and
- the precautions employed by the issuer to prevent the resale of the underlying securities.⁵¹

Application of the Section 4(2) criteria may result in lack of certainty, an especially troublesome consequence for market participants desiring successful consummation of "transactions."⁵² Consequently, Rule 506 of Regulation D ("Reg D"), with its comparative certainty of application, is the modern-day exemption of choice, particularly in the PIPE setting.⁵³

2. Rule 506 – Section 4(2) Safe Harbor

As a result of the commercial uncertainty created by the Section 4(2) exemption, the SEC promulgated Rule 506 of Reg D.⁵⁴ To place the importance of Rule 506 in its proper context in the PIPE setting, a review of this regulation is in order.

The first three rules of Reg D consist of general rules that apply to the Rule 506 exemption.⁵⁵ For example, Rule 501 is a definitional section that provides the meaning of several key terms used throughout Reg D.⁵⁶ A significant definition contained in Rule 501 is the definition of an "accredited investor," which the rule defines as any person who comes

51. *E.g.*, *Lawler v. Gilliam*, 569 F.2d 1283 (4th Cir. 1978); *Doran*, 545 F.2d at 893. The size of the offering and the number of securities offered were considered relevant at some point but evidently no longer. *See* STEINBERG, *supra* note 22, at 105.

52. *See* Sjoström, *supra* note 16, at 391 (noting that the application of Section 4(2) is complicated by the fact that neither the 1933 Act nor any of the rules promulgated thereunder actually defines "public offering").

53. 17 C.F.R. § 230.506 (2006). Other exemptions contained in Reg D include Rule 504 and Rule 505. *See* HR Series Compensation and Benefits, 2 COMP. AND BENEFITS, *supra* note 39, at § 10:92 (2008) (outlining the Regulation D exemptions available under Rules 504, 505, and 506).

54. *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 24 SEC Docket 1166 (March 8, 1982) (attempting to simplify and classify exemptions and to "achieve uniformity between federal and state exemptions").

55. These rules also apply, depending on the circumstances, to other Reg. D exemptions. For example, the definition of "accredited investor" applies to both Rule 505 and Rule 506. 17 C.F.R. §§ 230.501, 230.505, 230.506.

56. 17 C.F.R. § 230.501 (2006).

within one of several specifically enumerated categories at the time of the offering.⁵⁷

Similarly, Rule 502 contains important rules concerning integration, information requirements, and manner of offering limitations.⁵⁸ First, Rule 502 contains a significant provision concerning the integration of offerings.⁵⁹ Integration is the principle by which two or more offerings that are supposedly distinct and structured as separate may be “integrated,” or regarded by the SEC as one combined offering for which an exemption may not be available.⁶⁰ The regulatory policy underlying integration is rather straightforward—it prevents an issuer and its promoters from inappropriately circumventing the registration requirements imposed by Section 5 of the 1933 Act by breaking a larger and possibly non-exempt offering into smaller, seemingly exempt offerings.⁶¹ Integration analysis is particularly applicable to PIPE transactions since the fundamental structure of these deals involves two offerings—a registered offering effected subsequent to a private placement. As such, if these offerings were integrated and construed as one larger offering, a Securities Act registration violation would result.⁶²

There are generally two methods for determining if separate offerings are subject to integration. First, if the two separate offerings are not executed within six months of each other, Rule 502(a) provides a safe harbor for Reg D offerings, thereby signifying that integration will not occur.⁶³ Second, if offerings are made within six months of each other, a

57. 17 C.F.R. § 230.501(a)(3).

58. 17 C.F.R. § 230.502 (2006).

59. 17 C.F.R. § 230.502(a).

60. See generally Theodore W. Jones, *The Doctrine of Securities Act “Integration”*, 29 SEC. REG. L.J. 320 (2001) (assessing the impact of basic Securities Act concepts on the development of the integration framework in light of the evolution of domestic capital markets); Daniel J. Morrissey, *Integration of Securities Offerings—The ABA’s “Indiscrete” Proposal*, 26 ARIZ. L. REV. 41 (1984) (discussing the need for nuanced integration criteria to safeguard the registration process); Perry E. Wallace, Jr., *Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Businesses*, 45 WASH. & LEE L. REV. 935 (1988) (examining several approaches to reforming the integration doctrine).

61. See, e.g., *Donohoe v. Consol. Operating & Prod. Corp.*, 982 F.2d 1130, 1140 (7th Cir. 1992) (describing the purpose of the integration doctrine and giving deference to SEC interpretations of it); *SEC v. Murphy*, 626 F.2d 633, 645-46 (9th Cir. 1980) (finding integration where the defendant-appellant had offered shares of limited partnerships at different times, but for the same purpose, under a single financing plan, and in return the same type of consideration).

62. Sjostrom, *supra* note 16, at 395.

63. 17 C.F.R. § 230.502(a); see also 17 C.F.R. § 230.147(b)(2) (2006) (creating a six-month safe harbor from integration for intrastate offerings). But see Securities Act Release No. 33-8828, *supra* note 12 (proposing to decrease this safe harbor from six months to 90 days).

five-factor balancing test applies.⁶⁴ These factors are whether the offerings: (i) are part of a single plan of financing; (ii) involve the issuance of the same class of securities; (iii) were made about the same time; (iv) involve the same type of consideration; and (v) are made for the same general purposes.⁶⁵ When offerings transpire within the safe harbor time periods, thereby mandating application of this five-factor test, the ad hoc nature of the test along with inconsistent judicial interpretation has resulted in commercial uncertainty.⁶⁶ While the potential consequences of integration can be catastrophic, PIPE issuers generally are able to avert this risk by invoking Rule 152.⁶⁷ According to Rule 152 and SEC interpretations thereunder,⁶⁸ offerings made prior to a registration statement's filing and conducted under circumstances not mandating registration, do not by the fact of registration become the sort of offerings which are proscribed by the Securities Act.⁶⁹

64. Non-Public Offering Exemption, Securities Act Release No. 33-4552, 27 Fed. Reg. 11,316, 11,317 (Nov. 16, 1962).

65. *Id.*; 17 C.F.R. § 230.502(a); *see also* Jones, *supra* note 60, at 323-25 (explaining the five-factor test); Wallace, *supra* note 60, at 939-42 (identifying confusion surrounding the five-factor test).

66. *See* Leib M. Lerner, *Disclosing Toxic PIPEs: Why the SEC Can and Should Expand the Reporting Requirements Surrounding Private Investments in Public Equities* 58 BUS. LAW. 655, 675 (2003) (noting that since the SEC has stated that any of the factors can be determinative in the promulgation of the five-factor test, uncertainty is created for issuers over whether their offerings are subject to integration); *see also* Jones, *supra* note 60, at 325; Morrissey, *supra* note 60; Wallace, *supra* note 60, at 939-42 (all discussing aspects of the uncertainty created by application of the five-factor test).

67. 17 C.F.R. § 230.152 (2006).

68. *Id.* ("The phrase *transactions by an issuer not involving any public offering* used in section 4(2) . . . shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement."). As is evident from the SEC's approach to the application of Rule 152 in the context of PIPEs, the key analytical and factual consideration in this context is determining when the first phase of a PIPE transaction, typically the private offering, is complete. Pursuant to Rule 152's safe harbor and SEC interpretations thereof, a completed private offering component of a PIPE transaction will not be integrated with the subsequent public secondary offering if the first offering was properly "completed." The SEC's position is that a private placement of PIPE shares is "completed" for purposes of satisfying Rule 152's prerequisites if purchase commitments are in place from all participating investors such that the only existing contingencies are outside their control. *See Black Box Incorporated*, 1990 SEC No-Act. Lexis 926; *Squadron, Ellenoff, Pleasant & Leher*, 1992 SEC No-Act. Lexis 363. Essentially, these purchase commitments must unequivocally establish that there is no room for any further investment decision on the part of participating investors.

69. *See* SEC DIVISION OF CORPORATE FINANCE, MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS, at H (1997) [hereinafter SEC TELEPHONE MANUAL], available at <http://www.sec.gov/interp/telephone.shtml> (pointing out that the SEC interpretations even go so far as to allow an issuer to file a resale registration statement prior to the closing of the related private offering without the application of integration if: (i) the private offering investors are "irrevocably bound to purchase a set number of securities of a

Rule 502 also contains provisions that specify the manner in which Rule 506 offerings must be conducted in order to be eligible for exemption.⁷⁰ One such provision bans general solicitation and advertising.⁷¹ As interpreted by the SEC, a key criterion in determining whether a subject communication complies with the general solicitation and advertising bans is whether a pre-existing relationship existed with the prospective purchasers.⁷² A key basis underlying this criterion is that a pre-existing relationship enables the subject issuer and its financial intermediaries to assess investor suitability, namely, whether a prospective investor aptly can evaluate the merits of a contemplated investment.⁷³ In

set purchase price that is not based on market price or a fluctuation ratio, either at the time of effectiveness of the resale registration statement or at any subsequent date,” (ii) there are no conditions to closing that are within an investor’s control or that an investor can cause not to be satisfied,” and (iii) “[t]he closing of the private placement of the un-issued securities must occur within a short time after the effectiveness of the resale registration statement”); J.W. HICKS, LIMITED OFFERING EXEMPTIONS: REGULATION D § 3:9 (2007-2008) (discussing Rule 152); Sjostrom, *supra* note 16, at 396-97 (generally discussing the SEC Telephone Manual).

70. 17 C.F.R. §§ 230.506(b)(1), § 230.502(c) (2006). Similarly, Rule 502 also contains rules that require issuers to provide specified information to investors targeted in Reg D offerings. 17 C.F.R. § 502(b)(1) (2006). The applicability of Rule 502’s informational mandate generally hinges on the type of offeree a particular issuer is targeting in the private placement transaction. For example, if the issuer is targeting only accredited investors, as defined by Rule 501, the issuer is not subject to Rule 502’s informational requirements. Conversely, if the issuer is targeting non-accredited investors in addition to accredited investors, the issuer is required to comply with Rule 502’s informational prescriptions. Because Rule 506 transactions in the PIPE context normally are made solely to accredited purchasers, no mandated information must be delivered to comply with the exemption. *See* Dresner, *supra* note 1, at 65, 70.

71. 17 C.F.R. § 230.502(c) (“Neither the issuer nor any person acting on its behalf is permitted to offer to sell securities by any form of general solicitation or general advertising, including but not limited to (i) any advertisement, article, or other published or broad cast communication; or (ii) any seminar or meeting whose attendees have been invited by general solicitation or advertising”). Note that a violation of the general solicitation or advertising ban is not subject to the substantial compliance defense of Rule 508. 17 C.F.R. § 230.508 (2006).

72. Interpretive Release on Regulation D, Securities Act Release No. 33-6455, 1983 WL 409415 (March 3, 1983).

73. *See* Mineral Lands Research and Marketing Corp., 1985 SEC No-Action Letter, 1985 WL 55694 (arguing that the “manner of offering by the Company does not constitute general advertising or general solicitation because most of the offerees are a limited group with whom an officer and director of the issuer has a pre-existing business relationship”). More recently, the SEC has allowed issuers and financial intermediaries to demonstrate the presence of a “pre-existing relationship” by having an investor fill out a generic questionnaire about their investing habits in order to qualify them as accredited. This questionnaire, followed by a cooling off period, establishes a pre-existing relationship. *See* Lamp Technologies, Inc., SEC No-Action Letter, 1998 WL 278984 (May 29, 1998); Lamp Technologies, Inc., SEC No-Action Letter, 1997 WL 282988 (May 29, 1997); H.B. Shaine & Co., Inc., SEC No-Action Letter, 1987 WL 107907 (May 1, 1987); IPONET, SEC No-Action Letter, 1996 WL 431821 (July 26, 1996). As a result, today thousands of investors

the PIPE offering context, the invocation of the pre-existing relationship standard helps to ensure that the subject issuer can uphold the legality of the offering if challenged on grounds of general solicitation.⁷⁴

3. Rule 506

Turning to the primary exemption involved in many PIPE offerings, Rule 506 of Regulation D⁷⁵ serves as a “safe harbor” to the Section 4(2)

can access an issuer’s website, become pre-qualified and accordingly participate in Reg. D offerings without the issuer violating the general solicitation ban. *See generally* Katherine Killingsworth, *A History of General Solicitation Under the 1933 Act and Why Additional Guidance is Needed for the Future*, 33 SEC. REG. L.J. 47, 56-61 (2005) (discussing the formation of new pre-existing relationships and the implications of those relationships for the existence of a general solicitation); David B.H. Martin, Jr. & L. Keith Parsons, *The Preexisting Relationship Doctrine Under Regulation D: A Rule Without Reason?*, 45 WASH. & LEE L. REV. 1031, 1040-46 (1988) (criticizing the use of the pre-existing relationship test).

74. With respect to Rule 503, that rule provides that issuers relying on any Reg D offering must provide the SEC with notice of such by filing a notice on Form D. An issuer that violates this provision risks the penalty of disqualification from the ability to make additional Reg D offerings. 17 C.F.R. § 230.503 (2006). The SEC recently revised Form D. *See* Securities Act Release No. 8891 (2008).

75. 17 C.F.R. § 230.506 (2006). Note that other exemptions in Regulation D include Rules 504 and 505. Rule 504 is one of two limited offering transactional exemptions adopted by the SEC pursuant to its statutory authority under Section 3(b) of the 1933 Act. Essentially, Rule 504 facilitates capital formation by smaller start-up companies and does so by providing them with an exemption from the Section 5 registration mandate for offerings not exceeding \$1 million in any twelve month period. 17 C.F.R. § 230.504 (2006). In addition to the monetary limitation, the Rule 504 exemption may be used by issuers that are not reporting companies, investment companies or blank check companies. Further, in a Rule 504 exemption there are no limits on the number of investors that can participate, investor qualification is not required, and under certain circumstances, restrictions on general solicitation and resale are inapplicable. Under federal law, an issuer relying on the Rule 504 exemption is not required to provide specific offering information to investors. In practical effect, if a public Rule 504 offering is conducted, many states require the filing of a state registration statement. *See* STEINBERG, *supra* note 2, at 57-58.

Rule 505 contains an exemption for offerings not exceeding \$5 million in any 12-month period by issuers to no more than thirty-five non-accredited investors and an unlimited number of accredited investors. 17 C.F.R. § 230.505(a). Rule 505 investors are considered accredited if they fall into one of the categories enumerated in Rule 501(a), and, unlike in Rule 506 offerings, there is no requirement to qualify non-accredited investors as sophisticated. 17 C.F.R. § 230.505(b)(1)-(2). Additionally, an issuer is not eligible to rely on the Rule 505 offering if it is an investment company or otherwise disqualified according to Rule 252. 17 C.F.R. § 230.505(b)(2)(ii). Further, if a Rule 505 offering includes non-accredited investors, the issuer is obligated to fully comply with Rules 501 and 502. As with Rule 504, the Rule 508 substantial compliance defense is available to Rule 505 issuers in certain circumstances. 17 C.F.R. § 230.508(a)(1)-(3) (2006). Note, however, that the Rule 508 substantial compliance test is not available for violations of the ban on general solicitation, the limitation on the number of non-accredited investors, or the limitation on aggregate offering price. *Id.*; *see also* James R. Tanenbaum & Anna T. Pinedo, *The Law:*

statutory exemption described above.⁷⁶ Accordingly, if an issuer satisfies Rule 506's requirements, the offering falls within the exemptive scope of Section 4(2). However, unlike the Section 4(2) analysis, which focuses on offerees, Rule 506 is generally focused on purchasers.⁷⁷ Pursuant to Rule 506, there can be no more than thirty-five non-accredited purchasers and an unlimited number of accredited investors.⁷⁸ Further, while there is no express limit on the number of offerees that can be targeted in Rule 506 transactions, marketing the offering to a large number of prospective investors who have no pre-existing relationship with the issuer or financial intermediaries may violate the ban on general solicitation and advertising.⁷⁹ Additionally, accredited investors participating in a Rule 506 offering are irrefutably presumed to be financially sophisticated and to have access to registration-type information. Accordingly, Rule 506 does not require delivery of information to accredited purchasers. Generally, PIPE investors in a Rule 506 offering are all accredited purchasers.⁸⁰

Legal and Regulatory Framework, in PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY, *supra* note 1, at 77, 85 (discussing the Rule 504, 505, and 508 exceptions).

Importantly, unlike Rule 506 exemption, which is preempted from state regulation, §18(b)(4)(D) of the Securities Act, 15 U.S.C. § 77(b)(4)(D), the Rule 504 and Rule 505 exemptions are regulated by the states. Due to the objectives of avoiding additional costs and "overzealous" state regulators, PIPE offerings generally rely on the Rule 506 exemption.

76. 17 C.F.R. § 230.506(a)(2006) ("Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of [Rule 506] shall be deemed to be a transaction not involving any public offering within the meaning of section 4(2) of the [1933] Act.").

77. An exception to this generalization is Rule 502's ban on general solicitation and advertising. *See* 17 C.F.R. § 230.502(c).

78. 17 C.F.R. § 230.506(b)(2) (2006).

79. 17 C.F.R. §§ 230.506(b)(1), 230.502(c) (2006).

80. *See, e.g.*, Hicks, *supra* note 69, at § 1:17 ("an issuer is not required to deliver disclosure documents to accredited investors"). By contrast, with respect to non-accredited purchasers, such investors must meet financial sophistication standards and must be provided with disclosure of specified information. 17 C.F.R. § 230.506(b)(2). Note also that the substantial compliance defense is available to Rule 506 issuers and accordingly affords these issuers more flexibility in satisfying the prerequisites for the exemption. However, as with Rule 505, the Rule 508 defense is not available for violations of the ban on general solicitation or the number of non-accredited investors. *See* 17 C.F.R. § 508(a)(1)-(a)(3). Importantly, as stated above, an additional benefit of the Rule 506 offering is the preemption of state law regulation that it affords. *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996). In order for an offering to qualify for preemption of the state securities regulation framework, the securities being issued must be considered a "covered security" as defined in Section 18 of the 1933 Act. A "covered security" is defined to include securities issued under the Rule 506 exemption. *See* 15 U.S.C. § 77r(b)(4)(D) (2006).

Although not generally used in the PIPE context, there are several other exemptions from the registration requirement found in Section 5 of the 1933 Act. Section 4(6) of the 1933 Act, for example, is an exemption that reflects Congressional concern that small enterprises should not be unduly burdened in the process of raising capital. *See* Adoption of Interim Notice-Of-Sales Form for Transactions Pursuant to Section 4(6), Securities Act Release No.

III. EXAMINING THE PIPELINE

While traditional financing options theoretically are available to smaller publicly held companies, the use of a PIPE may represent the only viable financing option for such companies.⁸¹ For example, a primary public offering may prove impractical due to the lack of investment banker interest, insufficiently widespread support for the company or the securities to be offered, or the significant expenses that would be incurred.⁸² Similarly, many companies are unable to secure conventional debt financing either because of their overall credit unworthiness or as a result of the current credit market conditions that have constrained the overall level at which banks have an appetite to lend.⁸³ Moreover, even assuming

6256, 1980 WL 25728 (Nov. 7, 1980). In this regard, Section 4(6) exempts offers and sales from Securities Act registration by any issuer solely to “accredited investors” if the total amount raised does not exceed the limit articulated in Section 3(b) which is currently set at \$5,000,000. While Section 4(6) places no specified limit on the number of investors that can participate, all investors must be “accredited.” Significantly, no general solicitation is allowed and the securities issued in a Section 4(6) offering are restricted from resale. An issuer using Section 4(6) does not have to provide investors any specific offering information. Unsurprisingly, the Section 4(6) exemption is not often invoked because typically, if an offering is exempt under Section 4(6), it is usually exempt under Rule 506 – a more favorable option given the state law preemption Rule 506 affords.

Other exemptions from Securities Act registration include the intrastate offerings exemption (§ 3(a)(11) and Rule 147), the Rule 701 exemption (directed toward privately held business issuing securities as compensation to employees and consultants), and Regulation A (that allows a non-public company to raise up to \$5 million during a twelve-month period by conducting a “mini-public” offering). See STEINBERG, *supra* note 2, at 56-71 (discussing the exemptions just mentioned). These exemptions are rarely, if ever, employed in the context of PIPEs.

81. See Sjostrom, *supra* note 16, at 382 (noting that PIPEs often represent the only available financing option for many small companies).

82. See *supra* note 25 and accompanying text.

83. See Jane J. Kim, *Where Either a Borrower or a Lender Can Be*, WALL ST. J., Mar. 12, 2008, at D1 (“As the credit crisis spurs traditional lenders to tighten credit standards and raise fees, more small-business owners and entrepreneurs are turning to so-called person-to-person lending networks—with names like Prosper, LendingClub.com and Zopa.com — to help keep their businesses going.”); see also *The Credit Crisis: Financial Engine Failure*, ECONOMIST, Feb. 9, 2008, at 79 (“The extent of America’s economic woes was underlined on February 5th when signs of abrupt shrinkage in service industries in January helped push the S&P 500 stock market index down by 3.2%, its worst one-day fall in almost a year”). The article also found that, according to the most recent Federal Reserve quarterly survey of bank-lending officers, “the credit crunch was getting even crunchier” and as a result, “a good number of banks had imposed stricter lending standards and higher rates on loans since the previous survey, carried out in October [of 2007]. *Id.*; see also *The Credit Squeeze: Abandon Ship—The Credit Squeeze*, ECONOMIST, Aug. 4, 2007, at 58 (“The stockmarket has reacted with alarm to this credit squeeze, partly because it was counting on a continuous stream of debt-financed takeovers to push share prices higher. That confidence has now gone, and with it the market’s swagger.”); *Credit Markets: If at First You Don’t Succeed*, THE ECONOMIST, March 15, 2008 (“The fear is that the financial markets have

that these issuers are able to secure the debt financing that they seek, these lenders frequently will require the subject company to agree to onerous financial and operational covenants—concessions with respect to which the company may be unwilling or simply unable to adhere. Principally as a consequence of the foregoing considerations, in recent years, PIPE transactions have evolved as an increasingly popular and relatively inexpensive capital-raising technique.⁸⁴ The following discussion provides an overview of PIPEs as a transactional alternative to the currently elusive traditional sources of capital financing.

A. *PIPEs 101—The Basic Transaction*

As briefly discussed above, a PIPE is generally defined as “any privately negotiated equity or equity-linked investment in a public company.”⁸⁵ In a sense, a PIPE is a hybrid transaction that combines features of a traditional private placement transaction with a registered public offering.⁸⁶ To illustrate, a PIPE transaction typically begins with the consummation of a private placement, normally pursuant to Rule 506 of Regulation D. This private placement effectuates a PIPE purchaser’s direct investment into the issuing company.⁸⁷ Upon completion of the private placement and pursuant to the contractual terms negotiated, a subject issuer covenants to file a registration statement covering the shares purchased in the Rule 506 transaction.⁸⁸ Given this structural framework, PIPEs have achieved popularity because, if executed properly, they can provide an issuing company with the ability to raise capital fast and efficiently, while simultaneously offering investors the liquidity generally not available in a pure private-placement investment.⁸⁹

entered a negative spiral, the obverse of the kind of euphoria that drove dotcom stocks to absurd valuations in 1999 and early 2000. The problems are exacerbated by the demise of the [securitization] market, and fears about counterparty risk. Both those factors are making banks less willing to lend—even to worthy borrowers.”).

84. See E. Kurt Kim, *The Marketplace: A Statistical Summary*, in *PIPEs: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY* 27 (rev. and updated ed. 2006) (describing the evolution of PIPEs into a preferred financing tool from the mid-1990s until 2004).

85. Dresner, *supra* note 1, at 1.

86. Lerner, *supra* note 66, at 655-56.

87. Dresner, *supra* note 1, at 2-3; see also *supra* notes 75-79 and accompanying text.

88. See Jones et al., *supra* note 10, at 24 (describing the registration requirement typically required in a PIPE transaction as “a feature that makes PIPEs particularly appealing to private investors because it provides a potentially quicker and easier exit from the investment than other forms of private equity financing”).

89. See James F. O’Brien, Jr., *A Historical Perspective: The Bubble, Converts, and the Birth of Structured PIPEs*, in *PIPEs: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY*, at 53-62 (describing the rise in the popularity of PIPEs, which correlated with the rapid growth of capital markets during the 1990s); see also Lerner, *supra* note 66, at 657 (explaining that PIPEs allow companies to raise more capital than traditional private

From a “deal” perspective, a PIPE transaction includes a pure-equity or equity-linked investment by the respective investor into the issuing company.⁹⁰ Many issuers prefer this financing alternative because it allows them to secure capital without incurring the cost of a publicly registered offering up-front. Moreover, the discount provided in PIPEs to the current price for which a subject company’s stock is selling in the public markets is more advantageous than the discount generally applicable in a pure private placement transaction. Similarly, PIPEs offer subject issuers additional cost savings since these issuers are able to avoid some of the administrative and advertising costs associated with traditional public (primary or secondary) offerings.⁹¹

From an investor’s perspective, the principal highlight of a PIPE transaction is that these investors enjoy a level of liquidity not found in traditional straight private placement deals. Particularly, by requiring an issuing company to file and have declared effective a registration statement covering the underlying common stock, PIPE investors drastically reduce the illiquidity normally associated with generic private placements, thereby facilitating a cost-effective exit to their investment.⁹² Additional benefits for PIPE investors include: (i) their potential for superior returns; and (ii) the various other contractual features that enhance the overall security of the subject investment.⁹³

B. PIPEs—Structural Alternatives

Structurally, a PIPE transaction is the product of a heavily negotiated process and as such can take one of a myriad of forms based ultimately on the terms of the transaction, the securities involved, and the particularized needs of the issuer and investors.⁹⁴ Nonetheless, there are predominantly two forms a PIPE transaction can take: traditional or structured.⁹⁵

In a traditional PIPE, the issuing company covenants to file a registration statement covering the applicable securities with the SEC promptly after the closing of the private offering made pursuant to Rule

investments and to accurately predict the amount of cash that will be raised at the close of the transaction).

90. Dresner, *supra* note 1, at 2.

91. See Lerner, *supra* note 66, at 663-64 (noting that PIPEs are often more cost-effective for issuing companies, in part, because they afford these companies the ability to “bypass ‘road shows’” and advertising that are usually required for successful secondary public offerings).

92. *Id.* at 662; see also Jones et al., *supra* note 10, at 24 (explaining the liquidity advantages that make PIPEs attractive to private investors).

93. Lerner, *supra* note 66, at 662.

94. See Gormley, *supra* note 15, at 9, 13 (observing that the PIPE investment community “remains a highly negotiated marketplace”).

95. Sjöström, *supra* note 16, at 384.

506 of Regulation D. Accordingly, the private placement component is consummated before the registration statement covering the securities issued pursuant to it is effective. A traditional PIPE usually involves the sale of common stock at a fixed price that is determined in one of three ways: (i) a discount from market price; (ii) a premium to the market price; or (iii) at the market price of the company's common stock.⁹⁶

Alternatively, a traditional PIPE may consist of a sale of preferred stock which the investor has the option to convert into common stock pursuant to a negotiated and fixed conversion ratio. In a traditional PIPE involving preferred stock, the convertible preferred shares may also give the investor a right to dividends and similar rights in a sale, merger, or liquidation of the issuing company.⁹⁷ In fact, in many situations where an investor receives these additional benefits, the transaction is priced at or near the current market prices of the company's common stock.⁹⁸ One of the primary disadvantages inherent in the traditional PIPE structure is that, while the issuer is contractually obligated to file and have a registration statement declared effective, this process is subject to the SEC's regulatory scrutiny and can therefore be delayed.⁹⁹ This, in turn, creates a period of illiquidity that is ultimately factored into the investors' discount on the acquired securities. Additionally, since the private placement portion of the traditional PIPE deal is finalized prior to the filing of the registration statement, investors are committed to purchase, irrespective of whether there is a decline in the issuing company's stock price in the interim period between the private placement's closing and the registration statement's

96. *Id.*; see Gerald T. Lins et al., *Private Investments in Public Equities (PIPEs)*, in HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 6:39.50 (2007-2008 ed.) (explaining that the timing of registration statements for these securities allows quicker liquidity for investors); see also Harold S. Bloomenthal, *Small Businesses—Additional Regulatory Relief*, 30 No. 2 SEC. & FED. CORP. L. REP. 1 (Feb. 2008) (explaining the time period that a registration statement becomes effective after filing); Sarah S. Gold & Richard L. Spinogatti, *Corporate and Securities Litigation: SEC's PIPEs Short Sales Theory Fails*, 239 N.Y.L.J. 3 (col. 1) (Feb. 13, 2008) (noting that PIPEs may be exempt from the registration requirements that normally apply to public sales of unregistered securities).

97. Lerner, *supra* note 66, at 663.

98. *Id.* at 662.

99. See Prior Delivery of Preliminary Prospectus, Securities Act Release No. 4968, 34 Fed. Reg. 7235 (Apr. 24, 1969) (noting the high volume of registration statements the SEC must process); Elimination of Certain Pricing Amendments and Revision of Prospectus Filing Procedures, Securities Act Release No. 6714, 52 Fed. Reg. 21252 (May 27, 1987) (attempting to simplify the registration process); Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964, Exchange Act Release No. 31345, 57 Fed. Reg. 48970 (Oct. 22, 1992) (attempting to further reduce delays in the registration process); Carl Schneider et al., *Going Public: Practice, Procedure, and Consequences*, 27 VILL. L. REV. 1, 19-22 (1981) (describing the often frustrating process employed by the SEC when it reviews filings).

effectiveness.¹⁰⁰

Similar to the traditional PIPE, the structured PIPE is a transactional variety pursuant to which the issuing company generally will sell preferred stock or debt securities that are convertible into the company's common stock.¹⁰¹ Unlike the traditional PIPE, in a structured PIPE transaction an investor's obligation to purchase shares may be contingent on a registration statement covering those securities being declared effective by the SEC.¹⁰² In such transactions, the closing generally is delayed until the effective date of the registration statement. This enables the PIPE investor to engineer an exit strategy for its prospective investment prior to becoming legally obligated to acquire the securities.

In contrast to a traditional PIPE, the conversion price in a structured PIPE is usually variable and contractually linked to a reset mechanism that automatically adjusts the price downwards if the market price of the company's common stock falls below the conversion or reset price fixed at the time of issuance.¹⁰³ For this reason, a structured PIPE is generally more advantageous to PIPE investors because of the price protection afforded by the conversion ratio reset mechanism.¹⁰⁴

Concomitantly, this same feature makes the structured PIPE more

100. See Sjostrom, *supra* note 16, at 384. Approximately 83% of the 1,343 PIPE deals that closed in 2006 involved traditional PIPEs. *Id.*

101. See Jones et al., *supra* note 10, at 24 (noting that structured PIPEs generally involve the sale of: (i) convertible debentures or convertible preferred shares (where the conversion price is based on the future market price of the common equity), or (ii) convertible and common equity with a reset feature (where the share price or conversion price is reduced at a later date if the share price goes below a certain threshold), or (iii) fluctuating convertible (where the purchase price is linked to the future market price of the common equity - and as a result the securities issued in a structured PIPE frequently represent a larger percentage of the issuer's outstanding share capital than in a traditional PIPE)).

102. See Overview: *Private Investment in Public Equity ("PIPES")*, www.friedlandworldwide.com (July 25, 2005).

103. See O'Brien, *supra* note 89, at 61. Structured PIPEs often involve a sale of variable-priced securities (for example: floating ratio convertible debt) or a sale of securities accompanied by variable-priced sweeteners, which often lead to "toxic PIPES" or "death spirals" because these conversion ratios are inherently tied to the performance of the underlying stock after the PIPE issuance. As such, structured PIPEs enable investors to convert their PIPE securities into a greater number of issuer shares in the event the issuer's stock performs poorly after the PIPE is announced publicly and thus, arguably protects an investment against unexpected price declines that may occur during the period between the issuance and the effectiveness of the registration statement. However, these conversion ratios also render structured PIPEs more subject to market manipulation by investors, especially when one takes into consideration the aggressive short selling of the underlying equity shares that normally occurs during this interim period. Particularly, this shorting activity drives down the price of the issuer's stock while resulting in a more favorable conversion ratio. The primary problem with this strategy is that it can cause excessive dilution which diminishes the value of other existing shareholders' shares.

104. See Sjostrom, *supra* note 16, at 384-85 ("[W]ith a structured PIPE, investors do not assume price risk during the pendency of the resale registration statement").

risky for issuers since the conversion ratio may be calibrated in a way that, when triggered by the downward movement of the stock's price, exposes the company's existing shareholders to a significant risk of dilution.¹⁰⁵ The dilution risk inherent in structured PIPE transactions is evidenced in the PIPE transactional paradigm known as a "death spiral" or "toxic PIPE."¹⁰⁶ In these infamous PIPE transactions, reset provisions function as generally designed to automatically reset the exercise price if the price of the underlying stock falls below a contractually established threshold. As a consequence, this extreme downward pressure is placed on the underlying PIPE shares, a reality that is often compounded by the aggregate impact of investors shorting the stock on the open market. The cumulative effect of this shorting activity places greater downward pressure on the stock's market price, which in turn enables PIPE investors to make higher returns pursuant to their automatic reset provisions.¹⁰⁷ This downward pressure on the stock price, accelerating a dilutive cycle, adversely impacts the issuer's public shareholders. In sum, "[b]ecause the reset provision rewards the [PIPE] investor with more shares to match the original investment, this means that the lower the stock price goes, the greater dilution from conversion of the preferred, and the less value each common share holds."¹⁰⁸ The "death spiral" scenario is partly responsible for the negative perception that dominated during the early days of the PIPE's emergence onto the capital financing landscape.¹⁰⁹ Nonetheless, more recently, both the private and regulatory sectors have responded in a manner that largely has relegated the "death spiral" to the proverbial sidelines in the context of PIPE transactions. Thus, while the conditions surrounding these "toxic" transactions had deleterious effects on the PIPE market, they also led to innovative responses that serve a remedial role in the demise of "death spirals."¹¹⁰

C. *PIPEs—Market Evolution*

PIPEs emerged onto the investment landscape as a capital financing alternative approximately twenty years ago. During early days, PIPEs were regarded as a disfavored financing alternative generally used only by cash-strapped small-capitalization companies in dire need of financing. However, as time went on, both the investment community and issuers

105. See Lerner, *supra* note 66, at 664-66 (describing the toxic PIPE transaction).

106. *Id.* at 657-61.

107. See Lerner, *supra* note 66, at 664-66; Sjostrom, *supra* note 16, at 385.

108. Lerner, *supra* note 66, at 664.

109. *Id.*

110. *Id.* The foregoing overview illustrates how a PIPE transaction provides issuers with the ability to efficiently raise capital in a targeted, customized manner. See Gormley, *supra* note 15, at 15.

alike began to realize the versatility inherent in the PIPE transactional structure and increased the rate at which they resorted to it as a capital-raising strategy.¹¹¹ Gaining recognition, PIPEs today have expanded to include more established issuers who seek to benefit from the efficiency and cost effectiveness that PIPEs bring to the table.¹¹²

D. PIPEs—Transactional Considerations

Traditionally, PIPEs have been viewed as an important financing alternative for relatively small companies. In fact, recent estimates indicate that smaller companies still represent the largest category of PIPE issuers.¹¹³ Yet, while micro-cap (i.e., companies with a market capitalization of under \$250 million) to mid-cap companies (i.e., companies with a market capitalization of between one and five billion) traditionally have comprised the largest constituency of PIPE issuers, a new group of investors, namely hedge funds, are increasingly developing a financial appetite for PIPE transactions. To illustrate, recent estimates indicate that hedge funds currently constitute about 80% of the investors in micro-cap PIPEs. PIPEs are attractive to hedge funds because they provide an optimal transactional context in which these funds can leverage their technical expertise by using sophisticated trading strategies. Hedge funds often use a strategy whereby they sell short the issuing company's common stock promptly after a PIPE deal is closed. By using this strategy, hedge funds may effectively lock in the purchase discount, thereby profiting irrespective of a rise or fall in the issuer's share price.¹¹⁴

However, this portrayal of hedge funds being able to effortlessly reap the benefit of PIPE transactions is often not the reality. Specifically, in order to execute their short-selling strategy, hedge funds must be able to secure (normally through borrowing) shares to cover their short position. At times, the strategy has been impeded because some PIPE issuers have thinly-traded stock, and consequently, investing hedge funds trading in such PIPE shares may not be able to find enough shares to cover their short positions.¹¹⁵ That deficiency has prompted some hedge funds to rely on what are known as "naked shorts."¹¹⁶ The SEC, displeased with this

111. *See id.* (describing the growth of the PIPE market as a financing option).

112. *Id.* at 19.

113. *Id.*

114. *See* Sjostrom, *supra* note 16, at 387.

115. *Id.* at 388.

116. According to the SEC, "[i]n a 'naked' short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due; this is known as a 'failure to deliver' or 'fail.'" Naked Short Sales, <http://www.sec.gov/answers/nakedshortsale.htm> (last visited Oct. 21, 2008).

allegedly illegal strategy, has stepped up its regulatory oversight of hedge funds in the PIPE arena accordingly.¹¹⁷

Like any complex business transaction, a PIPE “deal” is completed by the execution of a number of different agreements, including: (i) a Securities Purchase Agreement; (ii) a Registration Rights Agreement; (iii) a Warrant Agreement (assuming applicability); and (iv) a Legal Opinion. Generally, after the completion of the preliminary and subsequent negotiation phases of the PIPE offering, the issuer and investors will agree on final versions of the foregoing agreements described above and execute them. Subsequent to the closing, the company will endeavor to prepare and file a registration statement covering the securities, thereby enabling the non-affiliated investors to freely resell the securities. Usually, the issuer will be required to file the registration statement anywhere between 90 and 120 days after the closing of the PIPE transaction. In most cases, the issuer will be contractually obligated to use its best efforts to have the registration statement declared effective by the SEC, an event that constitutes the consummation of the PIPE transaction.¹¹⁸

117. For example, in *SEC v. Langley Partners, L.P.*, Langley Partners, North Olmsted Partners and Quantico Partners (collectively, “Langley”) and their portfolio manager, Jeffrey Thorp (“Thorp”), established naked short positions in a PIPE issuer through Langley Partners’ Canadian broker-dealer prior to the effective date of the resale registration statement covering the underlying PIPE shares. In order to cover its short positions, Langley Partners either: (i) directly transferred its PIPE shares to its Canadian account or instructed its Canadian broker to sell its PIPE shares on a particular exchange and buy the same number of shares at the same time and price on the same exchange, (ii) journaled its PIPE shares from its cash account at its prime broker to its short account with instructions to cover its short position, or (iii) used cooperating market makers to purchase the PIPE shares from Langley Partners and then sell the shares back to Langley Partners, where the “washed” shares were used to cover the short position. The SEC charged Thorp with a violation of Section 5 of the Securities Act, alleging that he covered the pre-effective date short positions with shares he received in the PIPE transaction (or with “washed” shares) and “shares used to cover a short sale are deemed to have been sold when the short sale was made.” Thus, the SEC alleged that “Thorp and Langley employed an unlawful trading strategy in violation of the antifraud and registration provisions of the federal securities laws.” Complaint, *SEC v. Langley Partners, L.P.*, No. 1:06CV00467 (D.D.C. 2006); *see also* *In re Spinner Asset Mgmt., LLC and Spinner Global Tech. Fund, Ltd.*, Securities Act Release No. 8763 (Dec. 20, 2006) (alleging that a company placed matching buy and sell orders with respect to the PIPE shares in order to “make it appear that [it] was covering the short positions with open market shares,” and as such violated Section 5 of the 1933 Act); Complaint, *SEC v. Friedman, Billings, Ramsey & Co.*, No. 06-CV-02160 (D.D.C. 2006) (alleging that a violation of Section 5 of the 1933 Act occurred where FBR sold shares short prior to effectiveness of PIPE issuer’s registration statement, purchased the PIPE shares from FBR clients that invested in the PIPE and then used the shares to cover its preexisting short position).

118. While a PIPE issuer’s obligation to have the SEC find effectiveness after the registration statement is generally limited, the issuing company will generally be required to keep the registration statement current during the entire time that the PIPE investors are actively engaged in the reselling of their restricted securities pursuant to the registration

IV. RECENT REGULATORY DEVELOPMENTS IMPACTING PIPES

While the foregoing discussion highlights PIPES as a relatively inexpensive and effective alternative that enables a company to attain capital financing, there are a number of recent regulatory developments that have impacted the vitality of the PIPE market. This section of the article discusses these developments and assesses their overall cumulative impact on the PIPE market.

A. *Potentially Positive Developments*

1. Rule 144 Amendments

Recently, the SEC comprehensively amended Rule 144 in a manner that may benefit PIPE transactions.¹¹⁹ In particular, the SEC shortened the holding period requirement under Rule 144 for “restricted securities” of issuers that are subject to the Exchange Act reporting requirements. Pursuant to the recent amendments, the new six-month holding period requirement (from the previous one-year period) will apply to the securities of an issuer that has been subject to the reporting requirements of Section 13 or 15(d) of the 1934 Exchange Act for a period of at least 90 days before the Rule 144 sale.¹²⁰ In amending the Rule, the SEC stated that a core objective of Rule 144 is to provide clear and objective criteria for determining whether a person reselling securities initially acquired in a

statement. *See* Sjostrom, *supra* note 16, at 393-95.

119. Revisions to Rules 144 and 145, Securities Act Release No. 33-8869, 72 Fed. Reg. 71,546 (Dec. 17, 2007) (hereinafter “Rule 144 Release”).

120. *See* 17 C.F.R. §§ 230.144 (2006) (addressing the calculation of the holding period of restricted securities). Note that the issuer must continue to provide Exchange Act periodic reports for an additional six-month period. Rule 144 Release, *supra* note 118, at 71,550. Restricted securities of a “non-reporting issuer” will continue to be subject to a one-year holding period requirement. *Id.* at 71,549. A non-reporting issuer is one that is not, or has not been for a period of at least 90 days before the Rule 144 sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act. *Id.* at 71,568. The SEC believes that different holding periods for reporting and non-reporting issuers are appropriate given that reporting issuers have an obligation to file periodic reports with updated financial information (including audited financial information in annual filings that are publicly available on EDGAR, the Commission’s electronic filing system). *Id.* at 71,549. In 2006, the volume of transactions filed under Rule 144 exceeded \$71 billion, and more than 50% of U.S. public companies, large and small alike, every year have had at least one transaction reported on Form 144. *Id.* at 71,562. As such, decreasing the regulatory burdens associated with these transactions will ultimately reduce the cost of capital to these companies. *Id.* Note, moreover, that with respect to restricted securities of non-reporting companies, a non-affiliate can freely resell all of its holdings (not subject to a volume limitation) after a one-year holding period. *Id.* at 71,550. This is an expansion from the previous two-year period.

transaction that rendered them restricted did so with impermissible distributive intent. In this regard, the Rule 144 holding period has traditionally been a key criterion established to demonstrate that a selling security holder did not acquire the securities sought to be sold under Rule 144 with impermissible distributive intent. The SEC further asserted that reducing the holding period to the new six-month requirement would remove unnecessary impediments to the process of capital formation and will, as a result, have an overall beneficial impact on the private placement market.¹²¹ Indeed, most commentators that have opined on the overall impact of the recent amendments have observed that the new holding period will increase the liquidity of privately sold securities and decrease the cost of capital for reporting issuers.¹²² Indeed, the SEC's endorsement of the six-month holding period illustrates the Commission's commitment to the implementation of rules that help companies, especially smaller companies, raise capital more efficiently and less expensively.¹²³

Nonetheless, two commentators, namely the North American Securities Administrators Association (NASAA) and one of these authors¹²⁴ take the position that the SEC's six-month holding period is unduly short and makes a mockery of existing case law. For example, in *United States v. Sherwood*,¹²⁵ the federal district court applied a two-year holding period as a crude rule of thumb to determine whether the subject shareholder took with distributive intent.¹²⁶ In adopting Rule 144 in 1972, the SEC held firm to this two-year holding period.¹²⁷ Over the years,

121. See Rule 144 Release, *supra* note 119, at 71,549 (stating that the SEC did "not want the holding period to be longer than necessary or impose any unnecessary costs or restrictions on capital formation" and that "[a]fter observing the operation of Rule 144 since the 1997 amendments, [the SEC] believe[s] that a six-month holding period for securities of reporting issuers provides a reasonable indication that an investor has assumed the economic risk of investment in the securities").

122. Chivers & Cole, *144A Offerings—Potential New Liquidity Option for Sponsors* (Dec. 2007), <http://www.weil.com/news/pubdetail.aspx?pub=8504>.

123. According to the SEC, "by making private offerings more attractive, the amendments may allow some companies to avoid certain types of costly financing structures involving the issuance of extremely dilutive convertible securities"). SEC Release, *supra* note 119.

124. See Rule 144 Release, *supra* note 119, at 71,548 n.32 (noting NASAA and Marc I. Steinberg).

125. *United States v. Sherwood*, 175 F. Supp. 480 (S.D.N.Y. 1959).

126. *Id.* at 483 ("The passage of two years before the commencement of distribution of any of these shares is an insuperable obstacle to my finding that Sherwood took these shares with a view to distribution thereof, in the absence of any relevant evidence from which I could conclude he did not take the shares for investment."); see also SEC v. Kern, 425 F.3d 143, 148-50 (2d Cir. 2005) (finding a violation of Rule 144(k) when a seller of unregistered securities failed to allow two years to elapse between acquiring securities from the issuer and the execution of subsequent sales).

127. Definition of Terms "Underwriter" and "Brokers' Transactions," Security Act Release No. 5223, 37 Fed. Reg. 591, 593 (January 14, 1972). In that release, the SEC

through amendments to Rule 144, the Commission has decreased the two-year period to as short as six months.¹²⁸ Nowhere does the Commission

stated:

[A] holding period prior to resale [of restricted securities] is essential, among other reasons, to assure that those persons who buy [such securities in offerings exempt from registration] have assumed the economic risks of investment, and therefore, are not acting as conduits for sale to the public of unregistered securities, directly or indirectly, on behalf of an issuer. It should be noted that there is nothing in Section 2(11) which places a time limit on a person's status as an underwriter. The public has the same need for protection afforded by registration whether the securities are distributed shortly after their purchase or after a considerable length of time.

....

[Restricted] [s]ecurities sold in reliance upon the rule must have been beneficially owned and fully paid for by the seller for a holding period of at least 2 years prior to his sale as specified below. This condition is designed to assure that the registration provisions of the Act are not circumvented by persons acting, directly or indirectly, as conduits for an issuer in connection with resales of restricted securities. In order to accomplish this, the rule provides that such persons be subject to the full economic risks of the investment during the holding period

Id. at 593; see also Marc I. Steinberg & Joseph P. Kempler, *The Application and Effectiveness of SEC Rule 144*, 49 OHIO ST. L.J. 473, 482 (1988) (addressing the two year holding requirement for restricted securities).

128. See Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 7390, 63 SEC Docket 2077, at 1-2 (Feb. 20, 1997) (explaining the SEC's decision to shorten the holding periods for restricted securities). In that release, the Commission stated:

Today, for the first time since the adoption of Rule 144 in 1972, the Commission is adopting amendments to shorten the holding period that must be satisfied before limited resales of restricted securities may be made by affiliates and non-affiliates in reliance upon the rule. As had been proposed, the amendments reduce that holding period from two years to one year. Also as proposed, the amendments reduce the length of the holding period that non-affiliates must hold restricted securities before making unlimited resales of such securities from three years to two years.

The Commission is adopting the shortened holding periods based on its more than 20 years of experience with Rule 144 and the favorable public comments received on the 1995 Release. Shorter holding periods should reduce the cost of capital. This particularly should benefit smaller companies, which often sell securities in private placements. A shorter holding period should lower the illiquidity discount given by companies raising capital in private placements and increase the usefulness of the Rule 144 safe harbor.

... The Commission believes that the shorter holding periods will not diminish investor protection, since they are sufficiently long to ensure that resales under Rule 144 will not facilitate indirect public distributions of unregistered securities by issuers or affiliates.

Id. at 2. See generally Rule 144 Release, *supra* note 119.

adequately explain how this new policy squares with established case law. Neither does the SEC reasonably set forth how this drastic shortening of the Rule 144 holding period promotes investor protection. Indeed, non-affiliates of non-reporting companies today can reload all of their holdings after a one-year holding period, with little information being available in the public domain.¹²⁹ Such lack of transparency in public markets may be

129. Generally, Rule 15c2-11 prohibits broker-dealers from publishing a quotation for any security unless specified information is available with respect to the issuer and the security. In effect, the rule prevents the widespread distribution of securities without certain minimal information being publicly available. Hence, Rule 15c2-11(a)(5) calls for the following information to be reasonably current and to be made reasonably available by the subject broker or dealer upon the request of a prospective purchaser:

- (i) the exact name of the issuer and its predecessor (if any);
- (ii) the address of its principal executive offices;
- (iii) the state of incorporation, if it is a corporation;
- (iv) the exact title and class of the security;
- (v) the par or stated value of the security;
- (vi) the number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year;
- (vii) the name and address of the transfer agent;
- (viii) the nature of the issuer's businesses;
- (ix) the nature of products or services offered;
- (x) the nature and extent of the issuer's facilities;
- (xi) the name of the chief executive officer and members of the board of directors;
- (xii) the issuer's most recent balance sheet and profit and loss and retained earnings statements;
- (xiii) similar financial information for such part of the two preceding fiscal years as the issuer or its predecessor has been in existence;
- (xiv) whether the broker or dealer or any associated person is affiliated, directly or indirectly, with the issuer;
- (xv) whether the quotation is being published or submitted on behalf of any other broker or dealer, and, if so, the name of such broker or dealer; and
- (xvi) whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

viewed as antithetical to the best interests of the investing public.¹³⁰

Nonetheless, one significant aspect of the recent Rule 144 amendments that will likely benefit certain PIPE investors is the SEC's decision not to adopt a proposed amendment that would have included a tolling provision. This tolling provision would have tolled or suspended the holding period for a security holder that maintained a short position in, or any put or other option to dispose of, the security equivalent to the restricted securities owned by the security holder. This particular amendment was originally proposed based on the SEC's concern over the effect of hedging activities that are designed to shift the economic risk of investment away from the security holder in the context of PIPE transactions.¹³¹ However, after considering the comment letters received on this topic, the SEC decided against adopting the proposed tolling provision. In doing so, the Commission noted that "in the current environment, the tolling provision would unduly complicate Rule 144 and could require security holders or brokers to incur significant costs to monitor hedging positions for purposes of determining whether they have met the holding period requirement."¹³² The SEC further noted that adopting the proposed tolling provision would likely frustrate the Commission's objective of streamlining Rule 144, seeking to reduce the costs associated with capital formation for relatively small companies.¹³³

In sum, the recent changes to Rule 144 will likely have a beneficial impact on PIPE transactions. These amendments reduce the regulatory requirements for the resale of securities and, to a large extent, simplify the process of reselling such securities.¹³⁴ Prior to the amendments, a security holder relying on the Rule 144 safe harbor for the resale of restricted securities was required to wait at least one year after the securities were last sold by the issuer or an affiliate before such securities could be legally sold under Rule 144. The recent Rule 144 amendments have reduced this holding period requirement to six months for the resale of restricted securities of Exchange Act reporting companies. One instant benefit that this change will have in the context of PIPE transactions is that it will increase the liquidity of securities sold in private transactions—a vital component of every PIPE transaction. Another benefit is that enhanced pricing efficiency should ensue, to the extent that companies will now be

130. See Marc I. Steinberg, *The Securities and Exchange Commission's Administrative, Enforcement, and Legislative Programs and Policies—Their Influence on Corporate Internal Affairs*, 58 NOTRE DAME L. REV. 173 (1982) (making this point with respect to other SEC actions). Please note that Mr. Obi does not concur in this paragraph of the article.

131. Rule 144 Release, *supra* note 119, 72 Fed. Reg. at 71,566.

132. *Id.* at 71,552.

133. *Id.*

134. The SEC nonetheless observed that it "will revisit the issue if [it] observe[s] abuse relating to the hedging activities of holders of restricted securities." *Id.*

able to sell securities in private offerings at prices closer to those that can be procured in the public markets, without the costs incurred in a traditional registered SEC offering. As a result, the Rule 144 amendments should further facilitate a subject company's ability to raise capital in private securities transactions through the effective and strategic use of PIPEs.¹³⁵

2. SEC Enforcement Actions

As briefly mentioned above, the SEC staff has recently elevated its regulatory oversight of certain PIPE transactions and the PIPE market as a whole. Due to the increasing complexity and prevalence of PIPE transactions,¹³⁶ the Commission's concern focuses on the possibility of investor abuse inherent in the PIPE transactional landscape. In fact, the SEC's recent regulatory activity in this context is premised on well-documented abuses in the PIPEs context, particularly the risk that the issuance of a large number of shares through a private offering can flood the market and have the unfortunate effect of diluting the value of shares held by other shareholders of the issuing company.¹³⁷ Based on this concern, the SEC has sought to reign in PIPE transactions and the PIPE market as a whole. A key component of the SEC's recent regulatory arsenal against PIPEs is the initiation of enforcement actions based on alleged Section 5 registration violations. The following discussion will illustrate that recent cases have questioned the ultimate viability of the SEC's Section 5 claims in this context, a result arguably beneficial to the PIPE market and its participants.

One of the most recent of the various regulatory tactics that has been employed by the SEC in connection with PIPEs is the use of enforcement actions premised on alleged Section 5 registration violations.¹³⁸ Since applicable securities laws provide that, absent an exemption, a security must be sold in compliance with the Section 5 registration requirement, *i.e.*, a registration statement is filed by the issuer and subsequently declared effective by the SEC, PIPE shares normally are issued pursuant to the Rule 506 exemption.¹³⁹ In a number of recent actions, the Commission has

135. See Max Frumes, SEC Shortens, Grandfathers Rule 144 Holding Funds, 5 PIPEs Report No. 22, at 1 (Dec. 18, 2007).

136. See *supra* notes 16-17 and accompanying text.

137. See Gold & Spinogatta, *supra* note 96, at 3 (“[PIPE enforcement] actions are part of the SEC’s aggressive enforcement effort aimed at perceived abuses involving PIPE transactions”).

138. See Sjostrom, *supra* note 16, at 407-07.

139. See *supra* notes 75-80 and accompanying text. The reliance of PIPE issuers on an applicable exemption is a factor that often leads PIPE issuing companies to require PIPE investors to contractually pledge that they will refrain from immediately selling or otherwise distributing PIPE shares in a manner that would jeopardize the continuing availability of the

asserted that short sales effected in connection with PIPE transactions constitute Section 5 violations “because shares used to cover a short sale are deemed to have been sold when the short sale was made.”¹⁴⁰ The locus of the SEC’s argument in these cases is not that the basic short selling activity itself is illegal. Rather, the SEC’s position, as articulated in several of these cases, is that PIPE investors violate federal securities laws when they use the actual restricted PIPE shares, as opposed to the respective companies existing unrestricted non-PIPE shares, to cover or otherwise close their short positions irrespective of the fact that a registration statement covering the subject shares had been declared effective prior to the covering. The critical analytical issue underlying the SEC’s position is the question of whether the commencement of a short sale of PIPE shares during the pendency of the registration statement constitutes a sale for purposes of determining compliance with applicable Section 5 requirements.

The Commission’s perspective is that such execution of a short position indeed constitutes a sale for Section 5 purposes. The first part of its analysis usually begins with the assertion that the subject securities were sold pursuant to a private placement exemption and were thus restricted from resale. Consequently, these securities could only be resold if they were registered with the SEC or an available exemption from registration is perfected.¹⁴¹ The SEC thereupon asserts that the defendant sold PIPE shares into the market prior to the subject registration statement being declared effective in strict contravention of the proscriptions found in Section 5.¹⁴² The Commission posits that the subject defendants

applicable exemption. *See* Gold & Spinogatti, *supra* note 96, at 3 (noting that “PIPE issuers customarily require investors to pledge that they will refrain from immediately redistributing their PIPE shares to the public in order to ensure the applicability of that exemption”).

140. *See infra* note 148 and accompanying text; *see also* Sjostrom, *supra* note 16, at 404. In practice, this often happens because investors want to hedge their investment during the period between the acquisition of the restricted shares and the effective date of the registration statement by selling short a corresponding number of the PIPE issuer’s publicly-traded securities. A conventional short sale is when an investor sells a security that he does not own by borrowing the security, typically from a broker, and at a later date the investor closes out the short position by purchasing the security and returning it to the lender. *See* 17 C.F.R. § 242.200(a) (2006).

141. 15 U.S.C. § 77d(1) (exempting from § 5 “transactions by any person other than an issuer, underwriter, or dealer”). Section 2(a)(11) of the Securities Act defines the term “underwriter,” among other things, as “any person who has purchased from an issuer with a view to . . . the distribution of any security.” *But see* 17 C.F.R. § 230.144(a)(3) (setting forth conditions under which a person who sells restricted securities “shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter thereof within the meaning of Section 2(a)(11) of the [Securities] Act”).

142. *See, e.g.,* Complaint, SEC v. Spiegel, Inc., No. 03C-1685, 2003 U.S. Dist. 17933 (N.D. IL 2003) at 6 available at <http://www.sec.gov/litigation/complaints/compl8020.htm>.

accordingly are selling PIPE shares in an unregistered manner not compliant with Rule 144 and are therefore presumed to be underwriters, and are thereby unable to avail themselves of the protection afforded by the Section 4(1) exemption. In the SEC's view, because these PIPE investors effectuated short sales that were not registered or privately placed via the perfection of an applicable exemption, their transactions, in essence, violated Section 5.¹⁴³

It has been suggested that, while the SEC's recent approach to short selling in this context may arguably have some theoretical substantive merit, it has anomalous practical effects, particularly since this regulatory interpretation does not advance the disclosure objectives underlying the Section 5 registration requirement.¹⁴⁴ Similarly, while the SEC's position on PIPE short sales as it relates to the Section 5 registration requirement is based on the perception that to do otherwise would enable hedging PIPE investors to inappropriately insulate their transactions from market risk, this rationale may be flawed because it infuses a formidable, yet unnecessary, regulatory impediment that constricts an investor's ability to utilize generally permitted trading strategies in the context of PIPE transactions.¹⁴⁵ Additionally, and indeed, somewhat inconsistent with the foregoing rationale, the SEC, in fact, has given its approbation to hedging in connection with PIPE transactions.¹⁴⁶

Notwithstanding the SEC's reliance on Section 5 as a regulatory

143. While the foregoing may indicate that the SEC has banned hedging in connection with PIPE transactions, this is actually not accurate. See *Spinner Asset Management, LLC*, SEC Order, Securities Act Release No. 2573 (Dec. 20, 2006) available at <http://www.sec.gov/litigation/admin/2006/33-8763.pdf>. In fact, in the foregoing recent administrative order the SEC articulated its position on the issue as follows:

Many PIPE investors 'hedge' their investment by selling short the PIPE issuer's securities before the resale registration statement is declared effective. There is nothing per se illegal about 'hedging' a PIPE investment by selling short the issuer's securities. Such short sales do not violate the registration provisions of the Securities Act if, among other things, the investor closes out the short position with shares purchased in the open market.

144. See *SEC v. Lyon*, 529 F. Supp. 2d 444 (S.D.N.Y. 2008). In this context the court found that "[i]n addition to its inherent logical implausibility, the SEC's characterization of a short sale does not advance the purposes that animate Section 5's registration requirement." *Id.* at 455 (citing *Pinter v. Dahl*, 486 U.S. 622, 638 (noting that "[t]he primary purposes of the Securities Act is to protect investors by requiring publication of material information thought necessary to allow them to make informed investment decision concerning public offerings of securities in interstate commerce.")).

145. See Sjoström, *supra* note 16, at 407-08 (arguing that there are at least two additional problems with the SEC's justification in this regard: (i) Section 5 is primarily concerned about ensuring adequate disclosure, not preventing investors from avoiding market risk and (ii) the SEC allows PIPE investors to avoid market risk by short selling so long as the short position is covered by shares purchased in the open market).

146. See *supra* note 143 and accompanying text.

sword in the PIPE context, a number of recent cases have squarely called into question the viability of the SEC's Section 5 interpretation as applied to PIPE transactions where investors hedge using short sales or similar transactions.¹⁴⁷ For example, in *SEC v. Mangan* the SEC filed an action against former Friedman, Billings, Ramsey & Co., Inc. registered representative John F. Mangan Jr. alleging, among other things, the sale of unregistered securities in violation of Section 5 and in connection with certain PIPE transactions. According to the complaint, Mangan allegedly purchased 80,000 shares of a Nasdaq-listed company, CompuDyne Corp., in a PIPE transaction. Similar to many other PIPE investors, the defendant in this case then hedged the PIPE shares by selling short an equal number of CompuDyne shares. The complaint further alleged that, subsequent to the private placement, CompuDyne filed a registration statement for the resale of its PIPE shares, and after this registration statement was declared effective, Mangan allegedly used the PIPE shares to cover his short position in the company's stock. The gravamen of the SEC's complaint was the contention that Mangan's short sales were equivalent to actionable violations of Section 5. Interestingly, unlike several other SEC enforcement actions in this area,¹⁴⁸ the SEC did not allege that Mangan's short sales were executed through "matched orders,"¹⁴⁹ "wash sales,"¹⁵⁰ or "naked,"¹⁵¹ shorts—transactions the SEC has historically seen as evidencing a deceptive intent. Rather, the SEC primarily alleged that Mangan violated Section 5 by engaging in a hedging strategy that consisted of him covering his pre-effective short positions with PIPE shares.¹⁵²

147. *SEC v. Lyon*, 529 F. Supp. 2d 444 (S.D.N.Y. 2008); Complaint, *SEC v. Mangan*, 2006 WL 4036641, No. 06-0531 (W.D.N.C. Dec. 28, 2006); Complaint, *SEC v. Berlacher*, No. 07-3800 (E.D. Pa. Sept. 13, 2007).

148. See *Langley Partners*, *supra* note 117 (alleging unlawful trading strategy involving washed shares). Note that the SEC has initiated several enforcement actions based on alleged insider trading in the PIPE setting. See, e.g., *SEC v. Deeplaven Capital Management, LLC*, SEC Lit. Rel. No. 19683 (D.D.C. 2006); *SEC v. Shane*, SEC Press Rel. No. 2005-76 (S.D.N.Y. 2005); *SEC v. Pollet*, SEC Lit. Rel. No. 19199 (E.D.N.Y. 2005). See generally WILLIAM H. WANG & MARC I. STEINBERG, *INSIDER TRADING* (2d ed. 2005).

149. "Matched orders" are a illegal manipulative technique of offsetting buy and sell orders to create the impression of activity in a security, thereby causing upward price movement that benefits the participants in the scheme. See, e.g., *SEC v. Lybrand*, 200 F. Supp. 2d 384, 389-90 (S.D.N.Y. 2002).

150. According to the SEC's articulation, a "wash sale" is when an investor buys and sells the same security at the same time or within a short period of time. Wash sales violate the federal securities laws, specifically Section 9(a)(1)(A) and Rule 10b-5 of the Securities Exchange Act of 1934, if they are done to create the false or misleading appearance of active trading in a security. See SEC, Wash Sales, www.sec.gov/answers/wash.htm (last visited Sept. 17, 2008).

151. See *supra* note 116.

152. This case is in line with several enforcement actions brought against PIPE investors by the SEC starting in 2005. In most of these cases, the SEC's primary basis for action has

In dismissing the SEC's complaint, the federal district judge in *Mangan* concluded:

The government's allegation of a Section 5 violation is certainly creative. And while there seems little doubt that the defendant sold short anticipating the receipt of PIPE shares to cover the short, it's also true that in any case he would have had to cover with the shares purchased in the open market should the PIPE fail to close or been withdrawn or otherwise not be available to produce those shares. Anybody who bought at the sale of the securities got CompuDyne. They got what they bought.¹⁵³

The *Mangan* decision, particularly its unequivocal rejection of the imposition of Section 5 liability based on such short selling activity, has been followed by at least two other courts.¹⁵⁴

been consistently predicated on the argument that short shares executed prior to the effective date of a registration statement were effectively unregistered and non-exempt sales of securities if the short positions were subsequently covered by the PIPE shares after the registration statement was declared effective. *See supra* notes 138-151 and accompanying text; *infra* notes 153-155 and accompanying text.

153. *See* Transcript of Proceedings before the Honorable Graham C. Mullen, United States District Court Judge October 24, 2007, at 43-44, SEC v. Mangan (No. 3:06-CV-531); *see also* SEC v. Mangan, 2007 WL 4102743 (W.D.N.C. 2007) (dismissing SEC's Section 5 claim for "the reasons stated in open court during the hearing").

154. SEC v. Lyon, 529 F. Supp. 2d 444 (S.D.N.Y. 2008); SEC v. Berlacher, 40 SEC. REG. & L. REP. (BNA) 149 (E.D. Pa. 2008). For example, in *Lyon*, during the period from 2001 to 2004, affiliates of hedge fund Gryphon Management Partners (collectively herein, "Gryphon") participated in approximately thirty-six (36) PIPE transactions. The SEC brought an action in which it alleged that Gryphon (i) violated Section 5 of the 1933 Act; (ii) committed securities fraud in violation of Section 10(b) of the 1934 Act; and (iii) committed insider trading in violation of Section 10(b) of the 1934 Act. 529 F. Supp. 2d at 447.

The first charge brought against Gryphon was a violation of Section 5 of the Securities Act. According to the SEC's theory in this case, Gryphon unlawfully sold PIPE shares to the public via a multi-step veiled process which effectively amounted to an unregistered three-step distribution as follows: *first*, Gryphon bought PIPE shares issued by publicly-traded companies that were restricted from being sold in the open market; *second*, it sold short the PIPE issuer's public shares prior to the effective date of a resale registration statement for the PIPE shares; and, finally, after the resale registration statements for the PIPE shares became effective, Gryphon covered its short positions with the newly-registered PIPE shares. *Id.* at 448.

The SEC contended that Gryphon's process, particularly its hedging activity, violated Section 5. As noted above, the heart of a Section 5 violation where a short sale is involved generally involves the determination of what security was sold when a purchaser enters into its short position. Here, the SEC contended that the unregistered PIPE shares shorted by Gryphon in some of its PIPE transactions were actually sold when Gryphon entered into its short position and thus Section 5 was violated through the public sale of unregistered shares. Disagreeing with the Commission's position, the court held that a short sale of a security constitutes a sale of that security and, as such, how an investor subsequently chooses to close the corresponding short position in her trading account does not alter the nature of that sale. As a corollary to this point, the court also noted that the SEC's claims were void of

The SEC's invocation of Section 5 in this factual context against hedging PIPE investors increases the uncertainty inherent in PIPE transactions and dissuades such investors from employing effective risk management trading strategies. PIPE issuers are similarly impacted because they may be compelled to compensate investors for this increased regulatory risk and its attendant costs through higher discounts and other contractual benefits. Hopefully, in light of recent judicial rejection of its position, the SEC will revisit its enforcement policies as they pertain to the application of Section 5 to short sales executed in connection with PIPE transactions.¹⁵⁵

any allegations that the defendants' actions prevented the short sale counterparties from accessing or otherwise acquiring the type of information required by the 1933 Act. In reaching this decision, the Court dismissed two telephone interpretations published by the SEC staff, one of which the Court acknowledged was consistent with the SEC's position in the litigation but which the Court determined was conclusory and contained no analysis. *Id.* at 454-59.

Thus, similar to the *Mangan* court, the court here rejected the SEC position and found that "[b]ecause construing a short sale as a sale of the security that is eventually used to close down the short position neither comports with the plain textual meaning of section 5 nor advances the statute's underlying purpose, the Court declines to apply that characterization of a short sale to the transactions at issue in [the] litigation." *Id.* at 455. In sum, the court found the SEC's argument "implausible" as well as unnecessary to achieve the critical investor protection objectives underlying Section 5, and not compelled by SEC precedent. Accordingly, the court dismissed the claims related to the violation of Section 5 of the 1933 Act. *Id.* at 459-60.

Similarly, in *SEC v. Berlacher*, the Commission's attempt to hold a hedge fund manager and several related parties liable for alleged violations of the Securities Act registration requirements in connection with short sales involving several PIPE transactions was rejected. As in the *Lyon* and *Mangan* cases previously discussed, the SEC here alleged that Berlacher and several of his related funds (collectively, "Berlacher") engaged in a manipulative trading scheme that relied on short selling shares that were being issued in certain PIPE transactions in which they participated. In particular, the SEC argued that after entering into or otherwise becoming aware of a PIPE transaction, Berlacher would "short" the issuer's stock. Then, subsequent to the SEC's declaration that the resale registration statement was effective, Berlacher would use previously restricted PIPE shares to cover their short positions—a course of action which is, in the SEC's perspective, prohibited by Section 5 of the 1933 Act. Reaching the same conclusion as that in *Lyon* and *Mangan*, the court dismissed the Section 5 claims. 40 Sec. Reg. & L. Rep. (BNA) 149 (E.D. Pa. 2008).

155. Another regulatory approach employed by the SEC in the PIPEs context has manifested itself in the form of insider trading and securities fraud claims predicated on Section 10(b) of the 1934 Act that stem from certain contractual restrictions that are frequently imposed on PIPE investors. In particular, PIPE securities offered by a subject issuer are generally exempt from Section 5 registration because they are issued pursuant to an exemption for nonpublic offerings such as Rule 506 of Regulation D. However, in order to qualify for the exemption, PIPE issuers often require purchasers to represent that, among other things, they do not have a present intention to distribute the PIPE securities they are purchasing and will refrain from doing so during the pendency of the registration statement. Based on these representations, the SEC has argued that short sales executed during the interim period in which the registration statement is pending evidence an intention to distribute the securities that renders any contractual representations made by the PIPE

B. Form S-3 Developments

1. Form S-3 Amendments - Background

Until recently, the SEC declined to set forth a formal position focusing

investors materially false and thus actionable under Section 10(b). For example, in the *Lyon* case, the evidentiary record indicated that the foregoing representations were made by Gryphon in each of the relevant PIPE purchase agreements. As such, pursuant to Section 10(b) of the Exchange Act, the SEC alleged that Gryphon made materially false representations to the PIPE issuers because Gryphon had, in fact, planned to distribute the purchased PIPE securities to cover the short sales into which they would soon enter. Gryphon maintained that such representations were not false because their short sales did not constitute a "distribution," as defined under the applicable securities laws, and thus they had not misrepresented its investment intention. In the end, the Court sided with Gryphon and accordingly dismissed the SEC's Section 10(b) claims. See 529 F. Supp. 2d at 450.

Similar to claims of securities fraud predicated on Section 10(b), the SEC has also increasingly relied on insider trading law as a basis for imposing liability on PIPE investors. See cases cited in *supra* note 148. The SEC asserts that PIPE investors who engage in short selling activity or otherwise transact in the shares of the PIPE issuer while in possession of material non-public information about the underlying PIPE offering often do so in violation of their contractual pledges to keep such information confidential. In this context, the SEC is essentially relying on the "misappropriation theory" pursuant to which "a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of that information." *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). Based on various documents, including, the private placement memoranda, purchase agreements, and other ancillary agreements, the SEC has claimed in several cases that the PIPE investor defendants either directly or indirectly assumed a duty of confidentiality that either expressly or constructively restricted their ability to trade on the information conveyed. See cases cited in *supra* notes 117, 148.

For example, in the *Lyon* case, in addition to the Section 5 claims, the SEC also alleged that Gryphon committed insider trading violations by shorting the publicly-traded securities of PIPE issuers while in possession of material, non-public information about the corresponding PIPE offerings and in violation of their contractual obligations to keep such information confidential. In particular, the SEC argued that Gryphon entered into confidentiality agreements or otherwise agreed to use the information provided by various PIPE issuers solely for the purpose of evaluating the underlying PIPE transaction. However, by trading on such information, according to the SEC, Gryphon misappropriated the confidential information in breach of a duty owed to the issuer and therefore committed insider trading in violation of Section 10(b). The court ruled that the SEC had stated a plausible claim on this basis, thereby denying the motion to dismiss. See 529 F. Supp. 2d at 451-53. The other two cases discussed in the Section 5 context also declined to grant the respective defendants' motion to dismiss. See cases cited in *supra* note 150. First, the *Mangan* court allowed the SEC to proceed with its insider trading allegations. See 2007 WL 4102743 (W.D.N.C. 2007). Similarly, while the *Berlacher* court actually dismissed the SEC's insider trading claims, it did so in a manner that permitted the SEC to replead its claims with sufficient particularity on what information the defendants were required to keep confidential. See 40 SEC. REG. & L. REP. (BNA) 149 (E.D. Pa. 2008). See generally Wang & Steinberg, *supra* note 148. Subsequently, the court in *Mangan* granted summary judgment to the defendant, thereby dismissing the SEC's insider trading claim. 2008 U.S. Dist. LEXIS 64814 (W.D.N.C. 2008).

on the applicability of Rule 415 in the context of PIPEs. Nonetheless, during the Securities Act reform process, the SEC staff appeared to be focusing on several characteristics of PIPE transactions in determining whether the post-execution distribution of securities constituted a primary offering.¹⁵⁶ The first issue was the size of the resale offering being registered. In particular, the SEC staff was more likely to consider offerings of shares representing more than 30% of the issuer's public float to be a primary offering.¹⁵⁷ The second issue that the SEC focused on was indicia of control by the selling stockholders, including any board representation or other contractual provisions enabling one to procure control. In this context, the more control, the more likely the SEC was to view the resale offering as a primary offering.¹⁵⁸

Recently, in response to questions from PIPE issuers, investors, and practitioners, the SEC in 2007 clarified its position on resale registration statements and noted that its basic threshold for determining whether a resale registration is a primary offering is if the relevant registration statement sought to register greater than one-third of the issuer's pre-PIPE public float. Additional factors the SEC considered included the number of investors, the length of time the shares were held prior to registration, the discount received by the investors, and the relationship of the selling shareholders and the issuer.¹⁵⁹

156. Greenberg, Traurig, LLP, *Real Time Legal, Regulatory & Tax Developments Impacting Hedge Funds, Private Equity & Investments*, PRIVATE FUNDS WEEKLY ROUNDUP, (Jan. 29, 2007), available at <http://gtlaw.com/pub/alerts/2007/0129.pdf>. In a primary offering, the proceeds (after expenses) are received directly by the company. By contrast, a secondary offering is generally a registered offering whereby a substantial portion of the proceeds of the offering go to the selling shareholders, not the issuing company. There is significance attributable to this distinction. In particular, more stringent regulatory requirements are often imposed on primary offerings. As such, there are potential consequences that could arise from the characterization of a PIPE resale offering as a primary offering rather than a secondary offering—a reality that is particularly important to PIPE issuers and investors. These consequences include: (i) the inability to use Form S-3 unless the issuer is eligible to use Form S-3 for primary offerings; and (ii) the possibility that selling stockholders would be considered statutory underwriters and as such, would be exposed to “Section 11” underwriter liability for disclosure deficiencies contained in the registration statement, and ineligible to use Rule 144 to resell any of the securities issued in the private placement transactions.

157. *Id.* For purposes of the 30% public float test, the numerator includes all fully-diluted securities held by the selling stockholder (including any shares issuable upon exercise of warrants or conversion of convertible securities, without regard to “blocker” provisions), while the denominator only includes actual outstanding shares held by non-affiliates.

158. *Id.*

159. See *supra* note 156 (*inter alia*, explaining the significance if an offering is viewed as a primary offering).

2. Form S-3 Amendments—Overview

Form S-3 is an abbreviated registration form available to domestic companies that satisfy its requirements. Prior to the SEC's recent amendments, Form S-3 was generally only available to issuers in at the market primary offerings of equity securities if, among other things, their non-affiliate equity market capitalization (i.e., public float) was \$75 million or more.¹⁶⁰ The primary advantage of Form S-3 is that it allows eligible companies to satisfy the disclosure requirements attendant to any registered offering by way of automatic incorporation by reference from the periodic reports the company is required to file pursuant to the Exchange Act.¹⁶¹ As such, Form S-3 provides issuing companies with a more versatile registration option because it enables them to avoid much of the preparation and other administrative costs that are typically associated with an offering made pursuant to other forms, namely Form S-1.

The recent SEC changes to Form S-3 in some ways expand the universe of eligible users. In particular, Form S-3, as amended, now qualifies issuers that do not satisfy the \$75 million public float requirement for its use in at the market primary offerings of equity securities if certain prerequisites are met. Specifically, according to the amended form, the issuer is eligible to use Form S-3 in such situations if it (i) meets all of the other registrant eligibility conditions traditionally applicable to the use of Form S-3; (ii) has a class of common equity securities that is listed on a national securities exchange; (iii) does not sell more than the equivalent of one-third of its public float in primary offerings under Form S-3 over the previous 12 calendar months; and (iv) is not a shell company and has not been a shell company for at least twelve calendar months before the filing of the registration statement.¹⁶²

In the final rule release announcing the Form S-3 amendments, the Commission articulated several reasons for the changes adopted. First, the SEC's decision to amend Form S-3 is, in part, attributable to the recommendations made by the Commission's Advisory Committee on Smaller Public Companies—a committee charged by the SEC in 2006 to assess the current regulatory system for smaller companies under U.S. securities laws. In particular, the Advisory Committee recommended, *inter alia*, that the SEC permit all reporting companies with securities listed on a national securities exchange or NASDAQ, or quoted on the Over-the-Counter Bulletin Board electronic quotation service, to be eligible to use

160. See General Instruction I.B.1 of Form S-3; see also S-3 Amendment Release, *supra* note 30, at 13 (discussing Form S-3's history and contemporary applications).

161. *Id.* See generally Barbara Banoff, *Regulatory Subsidies, Efficient Markets and Shelf Regulation -- An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984).

162. SEC Amendment Release, *supra* note 30.

Form S-3 if they have been subject to the Exchange Act's reporting requirements for at least one year and are current in their periodic reporting at the time of the filing.¹⁶³ While the SEC's ultimate amendments did not represent a wholesale adoption of the Advisory Committee's recommendations, some of them are nonetheless reflected in the new rule. An additional reason advanced by the SEC for the amendments of Form S-3 is the SEC's belief that the extension of Form S-3 to additional issuers should expand these issuers' access to the public securities markets and overall participation in capital formation transactions.¹⁶⁴ In this regard, the SEC noted that "[t]he shelf eligibility resulting from Form S-3 eligibility and the ability to forward incorporate information on Form S-3, therefore, allow companies to avoid traditional delays and interruptions in the offering process and can reduce or even eliminate the costs associated with preparing and filing post-effective amendments to the registration statement."¹⁶⁵ The SEC also cited the significant advances in the electronic dissemination and availability of issuer disclosure transmitted by means of the Internet during the last several years as an additional justification for the expansion of Form S-3 eligible users.¹⁶⁶

3. Form S-3 Amendments—Critique

The SEC's recent amendments of Form S-3 may have a profound impact on the PIPE market for several key reasons. First, in a move contrary to the recommendations of its Advisory Committee,¹⁶⁷ the SEC's amendments extend access to Form S-3 to only companies that either (i) satisfy the traditional Form S-3 requirements (primarily the \$75 million dollar float), or alternatively (ii) satisfy the new conditions articulated by the recent form changes.¹⁶⁸ However, while these changes benefit the PIPE market to a certain extent, some aspects of the SEC's changes may present formidable impediments to a PIPE issuer's ability to use Form S-3—a more advantageous option for the public registration component of PIPE

163. Recommendation IV.P.3. of the Final Report of the Advisory Committee on Smaller Public Companies (Apr. 23, 2006), at 68-72, available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>.

164. S-3 Amendment Release, *supra* note 30, at 7.

165. *Id.* at 6-7.

166. In particular, the SEC's position on this factor, as articulated in the final rule release provides that "[t]he pervasiveness of the Internet in daily life and the advent of EDGAR as a central repository of company filings have combined to allow widespread, direct, and contemporaneous accessibility to company disclosure at little or no cost to those interested in obtaining the information. For this, we think it is appropriate to once again expand the class of companies who may register primary offerings on Form S-3 in a limited manner." *Id.* at 6-8.

167. See *supra* note 163 and accompanying text.

168. See *supra* note 157 and accompanying text.

transactions.

One of these new conditions is the requirement that an issuer (not meeting the traditional public float requirements) be listed on a national securities exchange.¹⁶⁹ As such, while the rule will provide a benefit to many PIPE stock exchange listed issuers that were not previously eligible to use Form S-3 in connection with the registration of PIPE shares, these changes also simultaneously exclude a significant number of companies that would have been able, pursuant to the Advisory Committee's recommendations, to utilize Form S-3 to issue shares in registered direct offerings and to thereby maximize the benefit of smaller discounts that this alternative to the traditional PIPE structure affords. The SEC's rationale for conditioning eligibility under the new Form S-3 rules to issuers having a class of common equity securities that are listed on a national securities exchange is rooted in the Commission's primary directive—the furtherance of investor protection.¹⁷⁰

Particularly, the SEC believes that the following factors associated with listing on a national securities exchange will combine to ensure that the expansion of Form S-3 eligibility that will be precipitated by the recent amendments does not create room for abuse and therefore, the erosion of investor protection in the PIPE sector of the investment community. In the final rule release, the SEC articulated its position that the following "common attributes allow the exchanges to sustain efficient and liquid markets that should help monitor the expansion of shelf registration eligibility on Form S-3 and help mitigate any attendant risks posed by expansion."¹⁷¹ The common attributes are:

- "[T]he exchanges' listing rules and procedures, as well as other requirements, provide an additional measure of protection for investors. Exchanges have both quantitative and qualitative listing rules that are designed to evidence that their listed issuers meet specified minimum requirements

169. A "national securities exchange" is a securities exchange that has registered with the Commission under Section 6 of the Exchange Act. There are currently ten securities exchanges registered under Section 6(a) of the Exchange Act as national securities exchanges. These are the New York Stock Exchange, the American Stock Exchange, NASDAQ, the Boston Stock Exchange, the Chicago Board Options Exchange, the Chicago Stock Exchange, the International Securities Exchange, the National Stock Exchange (formerly the Cincinnati Stock Exchange), NYSE Arca (formerly the Pacific Exchange), and the Philadelphia Stock Exchange. In addition, an exchange that lists or trades security futures products (as defined in Section 3(a)(56) of the Exchange Act [15 U.S.C. 78c(56)]) may register as a national securities exchange under Section 6(g) of the Exchange Act solely for the purpose of trading security futures products. For purposes of new General Instruction I.B.6., however, only exchanges registered under Section 6(a) of the Exchange Act will be deemed to be "national securities exchanges."

170. See *supra* note 30, at 19-23.

171. *Id.* at 22.

when the issuer first lists on the exchange and thereafter.”¹⁷²

- “Initial listing standards serve as a means for an exchange to screen issuers and to provide listed status to issuers with sufficient public float, investor base, and trading interest to assure that the market for the issuer’s security has the depth and liquidity necessary to maintain fair and orderly markets;”¹⁷³
- “Maintenance listing criteria help assure that the issuer continues to meet the exchange’s standards for depth and liquidity;”¹⁷⁴ and
- “Exchange-listed securities also are subject to real-time reporting of quotation and transaction information, which benefits investors by apprising them of current market information about the security.”¹⁷⁵

Nonetheless, the SEC’s 2007 amendments expanding the scope of the Form S-3 contradicts the Commission’s principal rationale for the Form’s adoption. In promulgating the Form S-3 in 1982, the SEC “relie[d] on the efficient market theory, allow[ing] a maximum use of incorporation of Exchange Act reports and requir[ing] the least disclosure to be presented in the prospectus and delivered to investors.”¹⁷⁶ As then adopted, the Form S-

172. *Id.* at 21. For example, while exchange listing standards can vary from exchange to exchange, they generally uniformly require listed issuers to (i) meet certain standards relating to the number of public shareholders and shares outstanding, shareholder approval of specified matters, and in certain cases, earnings or income; and (ii) meet specified corporate governance standards, including the requirement that certain committees of the issuer’s board be composed solely of independent directors. In contrast, automated inter-dealer quotation systems such as the Over-the-Counter Bulletin Board and Pink Sheets do not provide companies with the ability to list their securities, but, rather, serve as a medium for the over-the-counter securities market by collecting and distributing market maker quotes to subscribers. As such, these automated inter-dealer quotation systems do not maintain or impose listing standards, nor do they have a listing agreement or arrangement with the companies whose securities are quoted through them.

173. *Id.* at 21.

174. *Id.*

175. *Id.*

176. Adoption of Integrated Disclosure System, Securities Act Release No. 6383, Exchange Act Release No. 18524, 1982 WL 90370 (Mar. 3, 1982). The U.S. Supreme Court recognized that the fraud-on-the-market theory creates a rebuttable presumption of reliance in Exchange Act Section 10(b) securities litigation. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 225 (1988) (holding that the presumption “relieves the Rule 10b-5 plaintiff of an unrealistic evidentiary burden, and is consistent with, and supportive of, the Act’s policy of requiring full disclosure and fostering reliance on market integrity.”). See generally MARC I. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* § 7.05 (2008); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992) (arguing that, while theoretical in construct, the fraud-on-the-market theory is extremely practical in its application); Jonathan R. Macey, *The Fraud on the Market Theory: Some Preliminary Issues*, 74 CORNELL L. REV. 923 (1989) (“After *Basic Inc. v. Levinson*, the issue of whether a particular stock traded in an

3 could be used in primary at the market offerings of common stock only if the subject issuer had filed its Exchange Act reports for at least a 36-month period and had a public float of \$150 million (or alternatively a public float of \$100 million and three million share trading volume on an annual basis).¹⁷⁷ In 1992, still adhering to the efficient market rationale, the Commission lowered the Form S-3 for issuers having such equity offerings to a 12-month reporting history and \$75 million public float.¹⁷⁸

The U.S. Supreme Court has given its approbation to the efficient market theory in the securities litigation context.¹⁷⁹ In ascertaining whether a subject security trades in an efficient market, lower courts view Form S-3 eligibility as a key criterion.¹⁸⁰ Given this history underlying the Form S-3's adoption and implementation, the SEC's expansion of Form S-3 to encompass issuers that may not be traded in an efficient market is a significant departure. Indeed, the Commission's 2007 amendments may be viewed as an effort to facilitate capital raising while implicitly rationalizing that any security listed on a national securities exchange is, by definition, traded in an efficient market. This rationalization, however, contravenes

efficient market will now become an important part of every fraud on the market case."); William K.S. Wang, *Some Arguments That the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1986) (questioning traditional assumption that market can efficiently price securities).

177. Securities Act Release No. 6383 (1982).

178. Securities Act Release No. 6964 (1992). This rule change allowed approximately 450 additional issuers to use the Form S-3 for such equity offerings. *Id.*

179. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The Supreme Court stated:

The presumption [of reliance] is . . . supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and hence, any material misrepresentations. It has been noted that "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed. Commentators generally have applauded the adoption of one variation or another of the fraud-on-the-market theory. An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

Id. at 246-47.

180. See, e.g., *Freeman v. Laventhol and Horwath*, 915 F.3d 193, 199 (6th Cir. 1995) (eligibility to use Form S-3 key factor); *Cammer v. Bloom*, 711 F. Supp. 1264, 1275-87 (D.N.J. 1989) (stating that companies entitled to use SEC Form S-3 would almost by definition encompass stocks traded in a "special developed market"); *Harman v. Lymphomed, Inc.*, 122 F.R.D. 522, 525 (N.D. Ill. 1988) (stating that Form S-3 status is perhaps the "most significant" factor that the market for the stock was efficient).

established doctrine that the critical inquiry is the market for that particular stock, not the location where such stock trades.¹⁸¹

On the other hand, from a capital raising perspective, by limiting the availability of the Form S-3 under the newly promulgated rules to companies that are listed on a national securities exchange, the SEC may impede the ability of an appreciable number of OTC companies to avail themselves of the transactional benefits inherent in the PIPE capital financing paradigm. As a result, the PIPE market may not be able to derive the benefits generated by other recent SEC regulatory changes. For example, as discussed above, the SEC in 2007 adopted amendments to Rule 144 in a move that will provide an added level of liquidity to PIPE investors by making their shares (of an Exchange Act reporting issuer) freely tradable, irrespective of registration, after a newly abbreviated holding period of six months rather than a year.¹⁸² This change, and most importantly, the level of liquidity it infuses was expected to increase both issuer and investor appetites for PIPEs and accordingly the overall level of PIPE transactions. However, the SEC's decision to exclude OTC companies from Form S-3 eligibility, hence increasing the costs of such public offerings, may adversely impact the number of PIPE transactions.

Another key consideration regarding the SEC's recent Form S-3 changes is the public float cap that is placed on the use of Form S-3. According to the new rule, issuers are permitted to use Form S-3 for the registration of securities that do not exceed one-third of the company's public float.¹⁸³ Although the SEC's final cap of one-third of the public float is larger than the cap that was originally proposed,¹⁸⁴ it places a firm limitation on the optimization of the PIPE market by restraining the size of PIPE transactions that can be executed pursuant to Form S-3 registration.

181. Harman, 122 F.R.D. at 525. *See In re Polymedica Corp. Securities Litigation*, 432 F.3d 1 (1st Cir. 2005); *In re Xcelera.com Securities Litigation*, 430 F.3d 503 (1st Cir. 2005); *Unger v. Amedisys, Inc.*, 401 F.3d 316 (5th Cir. 2005); *infra* note 185; *see also Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269-70 (5th Cir. 2007) (holding that plaintiffs must "demonstrate loss causation before triggering the presumption of reliance" and that "loss causation must be established at the class certification stage by a preponderance of all admissible evidence").

182. *See supra* notes 119-135 and accompanying text.

183. As discussed in the final rule release, it is important to note that the one-third cap imposed by the new General Instruction I.B.6. to Form S-3 is only applicable to offerings conducted pursuant to Form S-3. As such, an issuer that is prevented from utilizing Form S-3 due to the new volume limitation, is not precluded from registering a primary offering of securities on Form S-1 or executing private placements. However, an issuer that is forced to take this route will lose the efficiency benefits that are often attributable to offerings conducted pursuant to Form S-3.

184. As proposed, new General Instruction I.B.6. of Form S-3 would have limited the amount of securities eligible companies could sell in accordance with its provision to no more than the equivalent of 20% of their public float over any period of twelve calendar months.

According to the SEC, "raising the cap to one-third of public float will allow an offering that is large enough to help an issuer raise a relatively significant amount of capital when market opportunities rise, but still small enough for the SEC to moderate the expansion of shelf eligibility with appropriate attention to the protection for investors, including the effect such new issuance may have on the market for a thinly traded security."¹⁸⁵ Additionally, while the SEC believes that the volume limitation still will facilitate the promotion of capital formation (particularly for smaller companies) in a manner consistent with the furtherance of investor protection, its adoption of the amendments does not foreclose the possibility that it may revisit the appropriateness of the one-third cap in the future.¹⁸⁶

A major problem with the SEC's one-third volume requirement is that, in practice, it may be illusory. Under the 2007 amendments, an issuer must be listed on a national securities exchange in order to utilize Form S-3. As such, these issuers may be subject to abide by volume requirements mandated by the applicable exchange that in some situations may be more stringent than the SEC's one-third rule. For example, companies that are listed on the Nasdaq Stock Exchange are subject to its listing rules and requirements. One such requirement is Nasdaq Rule 4350(i)(D) (the "20 Percent Rule") pursuant to which a company cannot issue voting securities such as common stock, convertible preferred stock, or convertible debt and warrants in a private transaction, at a price less than the greater of book value or market value, constituting in the aggregate 20 percent or more of its common or voting power outstanding prior to such issuance.¹⁸⁷ Therefore, by allowing only companies that are traded on national exchanges (such as the Nasdaq) to invoke the revised Form S-3 rules, the Commission, in practical effect, ensures that an enterprise seeking to issue the one-third maximum of its public float (at less than the greater of market

185. See S-3 Amendment Release, *supra* note 30, at 18. The SEC's reference to "a thinly traded security" is an admission that any such security does not trade in an efficient market. Allowing such issuers to use Form S-3 for primary offerings of common stock is a significant departure from prior practice. See also *Harman*, 122 F.R.D. at 525 n.1 (stating that "[t]he SEC's explicit rationale for this [disclosure] system is that information on companies which file an S-3 form is widely available in the market, and therefore need not be disseminated in the prospectus"); *supra* notes 179-181 and accompanying text.

186. See S-3 Amendment Release, *supra* note 30, at 18.

187. See NASDAQ, Inc., Manual §4320(i)(D) (2008), available at <http://wallstreet.cch.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F1&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Fdequityrules%2F>.

Notwithstanding the prohibition contained in NASDAQ rule 4320(i)(D), "NASDAQ may make exceptions to the requirement when the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise and reliance by the company on this exception is expressly approved by the Audit Committee or a comparable body of the Board of Directors." *Id.* at IM-4340(a), n.1; see also Gormley, *supra* note 15, at 23.

or book value) will be impeded unless it procures shareholder approval.¹⁸⁸

V. CONCLUSION

The foregoing discussion confirms that the PIPE financing alternative has evolved into a versatile capital formation mechanism. In current market conditions, as the process of capital formation continues to undergo significant transformation, subject companies are now, more than ever, reluctant to incur the costs that are becoming increasingly associated with traditional capital formation options, like the registered offering or certain types of exempt offerings.¹⁸⁹ As such, PIPEs stand to serve as a flexible financing mechanism for issuers and an attractive investment alternative for investors.

In fact, the PIPE as a financing structural alternative is becoming a mainstay in the investment community, and several factors have combined to make this possible. First, as discussed in the introduction of this article, current market conditions have created an investment environment that has constricted traditional sources of capital. The credit market, in particular, has stalled and as a result, the traditional capital wells of private equity and bank debt also have faltered. Similarly, recent regulatory developments, including the amendments to Rule 144, have created an investment paradigm with the potential to optimize the value of PIPEs to issuers and investors.

Yet, while the foregoing paints an optimistic picture for PIPEs, this optimism is tempered by other developments that give rise for analysis. In particular, as PIPEs gained recognition, the SEC's regulation of PIPEs has correspondingly heightened. As a result of this amplified regulatory scrutiny, the value inherent in PIPEs may be constrained and thus not fully optimized. However, on balance, the stage has been set and PIPEs will likely remain a major player in the arena of capital formation alternatives. In summary, the pipeline is flowing—PIPEs continue to offer suitable issuers the opportunity to raise capital efficiently while providing investors with a versatile investment tool that seeks to maximize financial returns.

188. See Max Fumes, *SEC Shortens, Grandfathers Rule 144 Holding Periods*, The PIPEs Report, vol. V, No. 22 (December 18, 2007) (noting that "a company trying to issue 33% of its float may bump up against the Nasdaq limitation, and vice versa. But given the Nasdaq's built-in ceiling, securities experts wonder why the SEC is imposing a cap at all.").

189. The Regulation A, intrastate public, and Rule 506 (to non-accredited investors) exemptions are examples. Extensive costs are incurred and government regulation prevails in such offerings. See Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591 (1996) (describing the various exemptions to registration and their associated costs).